Mike Burns

From:	John Anderson
Sent:	Friday, December 23, 2011 4:02 PM
To:	John Anderson
Subject:	IMF working report and albania
Attachments:	IMF SE Euro report122311.pdf

Greetings all. Hope you are having a good holiday season. I want to bring to your attention the attached IMF working report, "The Impact of the Global Crisis on South-Eastern Europe." It is very comprehensive, and while I know many of you will not read it right now, it seems like a good resource to have on file for when you are writing about regional or country specific economic trends. Permit me to point out that Albania is the only country in the region to achieve positive GDP growth every year since 2007 (Table #1), with rates well above the EU average. "Albania's macroeconomic performance since the turn of the previous decade marked an impressive period of economic transition with *per capita* GDP in U.S. dollars more than doubling," the report says. "Aside from sound macroeconomic policies, structural reforms, such as supply-side tax reforms, financial market development, and large scale privatizations,
provided further strong incentives to invest in the country."

That gave me enough holiday cheer to want to share it! Hope you have a safe, healthy and prosperous 2012.
Best Regards, John Anderson/Podesta.

The Podesta Group provides representation to the government of Albania. Additional information is on file at the US Justice Department.

John Anderson | Principal

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IMF Working Paper

The Impact of the Global Crisis on South-Eastern Europe

Emidio Cocozza, Andrea Colabella, and Francesco Spadafora

INTERNATIONAL MONETARY FUND

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IMF Working Paper

The Impact of the Global Crisis on South-Eastern Europe

Prepared by Emidio Cocozza*, Andrea Colabella,^ and Francesco Spadafora^

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Abstract

This paper analyzes the impact of the global crisis on six South-Eastern European countries. The main objective is to compare macro-financial conditions and policies in the run-up to the crisis as well as to compare the policy responses to it, so as to highlight, *inter alia*, possible country-specific constraints. While sharing a common pre-crisis pattern of strong capital inflows and robust growth, a key difference in the conduct of macroeconomic policies is that some countries adopted expansionary (and procyclical) fiscal policies. These moves exacerbated external vulnerabilities and compromised the ability to discretionarily use the fiscal instrument in a countercyclical fashion.

JEL Classification Numbers: E63, F32, F34

Keywords: international capital flows, current account adjustment, IMF financial support

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I. Introduction

This paper analyzes the impact of the global crisis on six South-Eastern European (SEE-6) countries: Albania, Bosnia and Herzegovina, Republic of Croatia, former Yugoslav Republic (FYR) of Macedonia, Republic of Montenegro, and the Republic of Serbia[1].

While the beginning of the global crisis in advanced economies is usually dated to July 2007, its fallout started to affect the SEE-6 countries towards the last quarter of 2008, following the massive market turmoil triggered by the Lehman Brothers bankruptcy. An even worse wave of financial instability materialized since mid-February 2009, when the rating agency Moody's issued a report warning that it might downgrade those Western European banks that were heavily exposed to emerging European countries.

These events impacted the SEE-6 countries first through a financial channel, in the form of lower and more costly external financing, and subsequently through a trade channel, via a significant decline in exports. Pressures mounted on these countries' capacities to finance their current account deficits and external debts, but also to fund the governments' budget deficits in some cases. Given these economies' high dependence on foreign capital, the marked decline in private capital inflows led to abrupt contractions in domestic demand and sharp adjustments in current account deficits. In many SEE-6 countries, panic-driven runs on bank deposits threatened financial stability and exacerbated tight domestic credit conditions brought about by the drying up of foreign savings. Overall economic activity decelerated rapidly, and in 2009 crossed into negative territories in all countries except for Albania.

In Serbia and Bosnia-Herzegovina[2] an external financing gap opened up as a result of the domestic impact of deteriorating global conditions. In January 2009 and July 2009, respectively, these countries obtained financial assistance from the International Monetary Fund (IMF or the Fund) in order to support adjustment programs and restore macroeconomic and financial stability.

While financial conditions have greatly improved since the peak of the crisis, and an export-led recovery has been underway since 2010, the SEE-6 countries are currently facing a new deterioration of the economic and financial outlook in the near-term, mostly as a consequence of the sovereign debt problems in the Euro Area.

The main objective of this paper is to compare macroeconomic and financial conditions and policies in the SEE-6 countries in the run-up to the crisis, with a view to identifying differences in domestic strengths and vulnerabilities that may help explain the diverse performances of these countries throughout the turmoil, including in terms of access to multilateral financial assistance. We also compare the policy responses to the crisis, so as to highlight, *inter alia*, possible constraints due to country-specific factors.

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[1] We do not include Kosovo in our analysis as the country joined the IMF only in June 2009, and Article IV Reports are thus not available for the period covered.

[2] Bosnia-Herzegovina operates under a complex and fragmented political system. The Dayton Peace Agreement that ended the war in 1995 created a State government, with a very limited mandate, and two largely autonomous Entities, which exercise most of the economic power: the Republika Srpska (RS) and the Croat-Bosniak Federation of Bosnia-Herzegovina (Federation), itself divided into ten largely ethnic cantons. This structure complicates policy coordination between the Entities and the State (IMF, 2007e).

As a starting point, all of the countries displayed a common pre-crisis pattern, whereby strong capital inflows spurred a credit expansion that increased domestic demand but also accentuated external vulnerabilities. In particular, a widening of the current account deficit, often substantial and from an already high level, constitutes a distinguished feature displayed by these economies in the run-up to the crisis, usually accompanied by an increase in the external debt-to-GDP ratio. In some cases, high current account deficits reflected long-standing structural problems, including a persistent savings-investment gap and an unfavorable business climate; moreover, all SEE-6 countries presented a high degree of euroization of the financial system. Finally, they all shared a common heritage of a transition to a market-based economy.

Despite the above-mentioned common pattern, the SEE-6 countries featured important differences in the pre-crisis conduct of macroeconomic policies, which affected domestic risks and vulnerabilities to external shocks. The most notable among such differences is that, immediately before the outbreak of the crisis, Bosnia-Herzegovina, FYR Macedonia, Montenegro, and Serbia all adopted expansionary (and procyclical) fiscal policies, often predicated on privatization receipts or cyclical buoyancy in fiscal revenue[3]. It is noteworthy that these expansionary stances reversed tight fiscal policies that had allowed significant progress towards fiscal consolidation in the first half of the 2000s.

On the contrary, in Albania and Croatia fiscal policies were somewhat more cautious and attentive to external balance, although Croatia's fiscal stance right before the crisis appears expansionary by some measures alternative to the headline fiscal balance. However, it should be noted that, despite higher fiscal caution, budget financing in both countries became nonetheless more difficult as a result of the deterioration in external financing conditions triggered by the global crisis.

The procyclical fiscal stance adopted right before the crisis by most of the SEE-6 countries exacerbated the pressures that robust private domestic demand had been exerting on the current account deficit. Importantly, this expansionary drive greatly compromised these countries' capabilities of using discretionary fiscal policy countercyclically with a view to mitigating the fallout from the global crisis[4]. This is even more noteworthy if one considers that in some of these economies fiscal policy was the only tool available for macroeconomic management, given the constraints posed by the exchange rate regimes in place. As a result, when the crisis hit and available external financing dried up abruptly, most countries were forced to limit the use of fiscal policy to the play of automatic stabilizers; in some cases a procyclical fiscal tightening was eventually undertaken in order to help contain budget financing and external vulnerabilities, at the cost of compounding the contraction of domestic demand (IMF, 2011j, p. 33). Albania stands out as the only country in the group that was

[3] Some empirical evidence shows that a growth cycle based on domestic absorption leads to stronger revenue growth than an export-led expansion. Moreover, absorption cycles are associated with pro-cyclical fiscal policy behavior (Dobrescu-Salman, 2011).

[4] A question remains of whether these expansionary fiscal policies *de facto* provided some unintended but welcome stimuli, in light of the deep downturns triggered by the global crisis. Even if this were the case, these pre-crisis fiscal policies were not explicitly designed to meet the "*Three Ts Rule*" ("timely, targeted, and temporary") that underpinned the package of fiscal measures adopted, for example, in the context of the European Economic Recovery Plan of November 2008.

able to provide a non-negligible discretionary fiscal stimulus (partly financed through privatization receipts) that complemented automatic stabilizers in supporting the economy. To be sure, Montenegro too had adopted a discretionary fiscal stimulus in the fall of 2008 to counter the external shock; however, this expansionary stance had to be hastily reversed in mid-2009 in order to contain budget-financing requirements.

Apart from the limited fiscal space, differences in the policy response to the crisis across the SEE-6 countries can also be explained, to a significant extent, by the type of exchange rate regime in place. In fact, the countercyclical policy response was constrained by the fixed or quasi-fixed exchange rate regime in place in all SEE-6 countries except for Albania and Serbia, where a flexible exchange rate operated within an inflation targeting monetary framework. Monetary policy via interest rates was simply not available in Bosnia-Herzegovina and Montenegro, while it was explicitly committed to maintaining the stability of the currency in Croatia and FYR Macedonia, although in the former country liquidity to the banking system was amply provided through the easing of reserve requirements. FYR Macedonia's monetary tightening in April 2009 stood out, as most countries in the region generally reduced interest rates and relaxed reserve requirements in a countercyclical fashion.

On the contrary, and setting aside the financial and currency risks potentially associated with sharp movements of the exchange rate in a highly-euroized financial environment, the exchange rate regime worked as a shock absorber in Albania and Serbia, and allowed a countercyclical monetary easing. However, in Serbia the benefits from a depreciated currency were somewhat limited by the pass-through to domestic prices, in the context of a historically high inflation rate (the highest in the region before the crisis) and entrenched inflation expectations. Moreover, while Serbia's corporate sector faced high exposure to balance sheet effects associated with a currency depreciation, these effects were more muted in Albania, as the external debt-to-GDP and debt service ratios were the lowest in the group, and external financing needs were more contained.

When compared with the outcomes of the crises that hit some Asian countries in 1997-98, a strikingly different feature of the impact of the global crisis on the SEE-6 countries is the absence of currency-cum-banking crises. This outcome owes significantly to the overall soundness, at the outset of the crisis, of the SEE-6 countries' banking systems, which benefited from high capital and liquidity buffers, and were generally profitable.

In this regard, a key commonality across these countries in the run-up to the crisis was the use of macroprudential measures (most notably, reserve requirements) introduced by national central banks to contain both external borrowing and rapid credit expansion, with a view to safeguarding external and financial stability. While evidence on the ability of such measures to effectively achieve their intended objectives remains mixed, in any event they helped build-up capital and liquidity buffers that eventually proved to be crucial in strengthening the capacity of the banking systems to withstand the crisis relatively well. Moreover, the relaxation of reserve requirements during the crisis allowed the release of liquidity in foreign currency that contributed to safeguarding the fixed and quasi-fixed exchange rate regimes. In turn, and critically, the lack of an exchange rate crisis spared these financial systems from facing the dire consequences of currency depreciations in a highly-euroized financial environment, which magnifies foreign currency-related credit risk.

As far as the involvement of the IMF is concerned, our analysis suggests that no single pre-crisis vulnerability is alone capable of fully explaining the request of Serbia and Bosnia-Herzegovina for the Fund's financial assistance. In general, this decision may result from a delicate balancing act between the preferred pace of the needed domestic adjustment and the constraints (i.e., policy conditionality) attached to the official financing that helps smooth out the adjustment. Ultimately, the choice comes to depend on a variable combination of many factors, including the political willingness on the part of the national authorities to rely on an external anchor as a commitment device[5]. In turn, this willingness can be influenced by a country's past experience with a Fund program and the attitude of the public at large toward this option.

As a consequence, it is very unlikely that all of the reasons underpinning a country's decision to ask for the Fund's assistance are to be found in economic and financial data alone. For example, it is noticeable that Croatia did not request the IMF's financial support and was able to retain market access despite having the largest external debt-to-GDP and debt service ratios within the SEE-6 countries. On the positive side, Croatia's current account deficit was more contained, and its pre-crisis fiscal stance was somewhat more attentive to the external balance. In the same vein, a more cautious fiscal conduct and stronger investor confidence in Albania's medium-term fiscal sustainability may contribute to explaining why the country fared better than its peers through the crisis, despite having the highest government deficit- and debt-to-GDP ratios in 2007 among the SEE-6 countries.

It is also worth noting that the size of a country's expected external financing requirements[6], if thought of as a proxy of the probability that it faces an external financing gap, is necessarily an insufficient predictor of the likelihood of requesting IMF financing. For example, Croatia's projected external financing needs (37 and 30 percent of GDP in 2009 and 2010, respectively) were much higher than those projected for Bosnia-Herzegovina (11 percent of GDP annually over 2009-2011, mostly owed to the financing of the government budget deficit) and at least as high as those projected for Serbia (29 and 26 percent in 2009 and 2010, respectively) at the time when these two countries requested the Fund's financial assistance.

As a result, even in unsettled financial market conditions, a country's ability to maintain access to market financing (domestic or external) is key for the sustainability of high external and fiscal financing requirements. This ability may come to depend on the size (and trend) of the government's budget deficit and, more generally, on the confidence placed by financial markets on the sustainability of public finances and the soundness of macroeconomic

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[5] This means that a country's request for Fund financing does not necessarily imply that it has lost access to market financing. In the case of Serbia, it is explicitly recognized that an important feature of the Fund's role in the context of the January 2009-April 2011 Stand-by Arrangement (SBA) was to serve as an internal commitment device/external anchor for domestic policies; the financing role of the program, while providing a needed buffer, "*was probably not its most important feature*" (IMF, 2011g, paragraph 74). The same feature applies to the precautionary SBA approved in September 2011. In Serbia, the role of the Fund as a commitment device is epitomized by the fact that at the expiration of the 2009-11 SBA, the parliament rapidly adopted a pre-election populist fiscal decentralization law that transferred taxes equivalent to about 1.3 percent of GDP to local government without devolving commensurate spending responsibilities (IMF, 2011k).

[6] The current account deficit plus the amortization of the debt's principals and interests falling due.

fundamentals. In this regard, when Bosnia-Herzegovina approached the Fund, the budget deficit was set to double to about 8 percent of GDP in 2009 in the absence of corrective measures, and the capability of financing the fiscal gap through domestic or external sources was severely constrained. On the contrary, Croatia's budget deficit was smaller than Serbia's and was on a declining path, and the country was able to increase the recourse to banks to fund the fiscal financing gap. However, the risk of crowding out the private sector involved in this funding channel should not be overlooked.

But the ability to retain market access may also depend on the type of external financing. Cross-border bank loans (particularly when granted by foreign parent banks to their local subsidiaries), while empirically more volatile than other capital flows, are easier to rollover under some circumstances than, for example, sovereign debt. In this regard, the fact that the banking systems in the SEE-6 countries are largely owned by a small number of Western European banks was a decisive factor that shaped the ability and incentives of foreign creditors to coordinate (most notably through the so-called "Vienna Initiative") on a rollover of their exposures, thus avoiding potentially dangerous outflows of external financing. At the same time, it should be recognized that the dominant presence of foreign-owned banks exposes the SEE-6 banking systems to funding risks, in case of problems faced by the parent banks, or contagion risks through the common creditor channel (i.e., risks of contagion from a country-specific shock in the region).

Finally, retention of market access may very likely be related in part to factors that can rest outside of a country's control, such as investors' appetite for emerging market assets.

The recourse of Bosnia-Herzegovina and Serbia to the Fund's financial assistance to support an adjustment program inevitably raises the key issue of whether these two countries have eventually fared through the crisis better than their peers. In this regard, the contractions of GDP in Serbia and Bosnia-Herzegovina have been relatively contained from a regional perspective, despite that these countries underwent two of the largest fiscal consolidations among emerging European economies in 2009-11 (IMF, 2011e, Box 2.3, p. 19). In both countries, consumption held up relatively well (or softened less than what was experienced by their peers), partly reflecting the role of mattress money as a financial buffer in Serbia or moderate growth of wages and social benefits in Bosnia-Herzegovina. Moreover, amid a faster-than-anticipated decline in the current account deficits, in both countries external financing turned out to be higher than what was expected at the time of the programs' approvals. On the other side, it should be noted that the growth performance of the remaining SEE-6 countries varied widely through the crisis. In particular, Albania and Croatia, both of which managed to retain (by and large) market access and did not request the Fund's financial assistance, present the largest difference: the former was the only country who continued to grow, while the latter suffered the most severe and longest recession[7].

The impact of the global crisis has left the SEE-6 countries with three main macroeconomic legacies: on the positive side, a substantial correction in the current account deficit, even

[7] The Governor of Croatia's National Bank is reported to have regretted the decision of not asking for the Fund's assistance when the crisis struck. Reuters News, October 29, 2010. http://www.forexyard.com/en/news/Croatia-needed-IMF-in-09-still-in-slump-cbank-2010-10-29T103815Z-UPDATE-1

though partly reflecting absorption contraction; on the negative side, tighter credit conditions and a significant deterioration in public finances, with both larger budget deficits and higher debt-to-GDP ratios. Moreover, external debt has increased significantly since 2009. Going forward, these challenges will weigh on the pace of growth. The transition to a more balanced growth model, with a greater role for the tradable sector, is necessary so as to avoid the re-accumulation of past imbalances and vulnerabilities.

The rest of the paper is structured as follows. Section II analyzes the macroeconomic conditions prevailing in the SEE-6 countries in the years leading up to the crisis, emphasizing in particular the buildup of external vulnerabilities. Section III focuses on the policy responses on the part of the SEE-6 countries to contain the external and financial risks posed by the rapid credit growth spurred by large capital inflows. Section IV illustrates the immediate reaction of the SEE-6 countries to the challenges posed by the domestic impact of the global crisis. Section V presents some concluding remarks.

II. Pre-crisis Macroeconomic Conditions in the SEE-6 Countries: Commonalities and Differences

The SEE-6 countries displayed several commonalities as well as important differences in their economic and financial conditions before the global crisis impacted the region between end-2008 and early-2009.

The main commonalities were several years of robust growth, driven by large capital inflows that spurred rapid credit expansions and buoyant domestic demand. These developments were accompanied by increasing external imbalances, primarily in the form of widening current account deficits, but also rising external debt-to-GDP ratios. On the contrary, the public debt-to-GDP ratio had been declining in all of the countries but Bosnia-Herzegovina, and quite substantially so in FYR Macedonia, Montenegro, and Serbia.

Another key common feature was the broad soundness of the banking systems, largely as a result of foreign ownership of domestic banks and improved regulatory and supervisory frameworks.

The main differences in the pre-crisis conditions relate to the monetary and exchange rate regimes in place, as well as to the fiscal stance. The latter had turned expansionary in Bosnia-Herzegovina, FYR Macedonia, Montenegro, and Serbia just before the fallout from the global crisis hit the region. Converesly, the conduct of fiscal policy was relatively more prudent in Albania and Croatia[8].

[8] See Section III.C.

A. Fast Economic Growth in a Low Inflation Environment

All SEE-6 countries grew fast in the years leading up to the crisis (Table 1)[9]; at the same time, inflation was generally contained, at least until the occurrence of the global food and commodity price shocks of 2008.

Fast growth reflected a catch-up process towards the higher average income levels in the Europen Union, driven by strong capital inflows from abroad, mostly in the form of Foreign Direct Investments (FDI) and bank lending, and butressed by broadly sound macroeconomic and structural policies in the context of a Fund-supported program[10]. The prospects for accession to the European Union also provided a strong incentive for political and economic reforms in all of the countries. Rapid growth culminated in the 2007 peak, when economic activity was accelerating from the previous year across all countries.

Table 1

Real GDP Growth (percent)

	average 2001-2006	2007	2008	2009	2010*	2011*	2012*
European Union	2.2	3.3	0.7	-4.2	1.8	1.7	1.4
Emerging and Developing Economies	6.3	8.9	6.0	2.8	7.3	6.4	6.1
Central and Eastern Europe	4.8	5.5	3.1	-3.6	4.5	4.3	2.7
Albania	5.8	5.9	7.5	3.3	3.5	2.5	3.5
Bosnia-Herzegovina	4.6	6.2	5.7	-2.9	0.7	2.2	3.0
Croatia	4.5	5.1	2.2	-6.0	-1.2	0.8	1.8
FYR Macedonia	2.2	6.1	5.0	-0.9	1.8	3.0	3.7
Montenegro	3.8	10.7	6.9	-5.7	1.1	2.0	3.5
Serbia	5.1	5.4	3.8	-3.5	1.0	2.0	3.0

*projections
Source: IMF's *World Economic Outlook database* (September 2011) and Article IV Reports.

Within this general picture, some country-specific features stood out. Albania and Serbia enjoyed the fastest average growth rate in the group, at above 5 percent over 2001-06. Albania's macroeconomic performance since the turn of the previous decade marked an impressive period of economic transition with *per capita* GDP in U.S. dollars more than doubling. As a result, the country emerged from the low-income country group and graduated IDA. Aside from sound macroeconomic policies, structural reforms, such as supply-side tax reforms, financial market development, and large scale privatizations, provided further strong incentives to invest in the country (IMF, 2006a; IMF, 2009c).

[9] Data used throughout the paper usually reflect initial estimates included in annual Article IV Reports. These estimates may have subsequently been revised, and may differ from the latest estimates by national authorities. However, the qualitative results of our analysis are not affected by data revisions.

[10] All SEE-6 countries had recently had a Fund-supported program: Albania (Poverty Reduction Growth Facility-Extended Fund Facility 2006-09); Bosnia-Herzegovina (Stand-By Arrangement 2002-04); Croatia (precautionary Stand-By Arrangement 2004-06); FYR Macedonia (Stand-By Arrangement 2005-08); and Serbia and Montenegro (Extended Arrangement 2002-05).

Albania's growth rate accelerated further to 7.5 percent in 2008. In Serbia, fast economic growth reflected a significant fiscal and structural reform effort, including privatizations of banks (IMF, 2005a; IMF, 2005d).

In Bosnia-Herzegovina and Croatia, annual real GDP growth in 2001-06 averaged 4.5 percent, with private consumption and investment increasingly representing the major engines of growth. In Bosnia-Herzegovina, robust economic activity was underpinned by the currency board adopted in August 1997 and the effects of past reforms in key sectors, including the financial system. The acceleration of growth since 2007 was supported by large wage increases and a sizeable fiscal impulse (IMF, 2008i).

In Montenegro, economic growth averaged close to 4 percent in 2001-06, but strongly accelerated after the country gained independence in 2006, peaking at over 10 percent in 2007, driven primarily by massive FDI inflows and exceptionally rapid credit growth (IMF, 2008a). FYR Macedonia's growth rate was lower than the SEE-6 average, mostly as a result of a security crisis in 2001. Driven by exports, economic expansion accelerated in 2003-06, averaging over 3.5 percent each year, and a boom in domestic demand took place in 2007, with growth accelerating to 6 percent.

In 2007, growth was higher than the 2001-06 average in all SEE-6 economies. This notwithstanding, it is important to highlight two features that cast some shadows on the longer-term sustainability of these countries' growth model (European Commission, 2010, pp. 1-9). First, strong growth was mainly driven by consumption, given the predominance (at around 80 percent) of this demand component in total GDP. Investment played a more significant role in Albania, Bosnia-Herzegovina, and Croatia, and net exports were generally negative. Secondly, in term of the supply-side structure, capital accumulation was remarkably skewed towards the non-tradable sectors, such as financial intermediation, construction and real estate, and domestic wholesale and retail trade. As a share of total output, during 2000-07 manufacturing activity maintained its relative importance only in Albania and FYR Macedonia.

B. STRONG CAPITAL INFLOWS

Strong capital inflows and rapid credit growth stand out as two key common features of the SEE-6 countries in the run up to the crisis (Table 2). These developments owed to a crucial extent to the increasingly dominant presence of foreign banks, which account for the distinct form of financial integration with Western European countries shared by other European transition countries[11]. In 2008, the share of foreign-owned banks in the SEE-6 countries ranged from 75 percent of total assets in Serbia to close to 95 percent in Albania, Bosnia-Herzegovina, and FYR Macedonia (EBRD, 2009)[12].

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[11] See in particular (EBRD 2009, Chapter 3) for a thorough discussion on the role played by financial integration (and its modalities) in supporting the development model of European transition countries.

[12] In 2003, this share ranged from 23 percent in Montenegro to 80-90 percent in Bosnia-Herzegovina and Croatia.

Table 2

Financial Account Balance (percent of GDP)						
	2005	2006	2007	2008	2009	2010
Albania	3.9	3.3	8	14.4	11.7	9.6
Bosnia-Herzegovina	12.8	4.6	9	13.4	6.2	6.2
Croatia	10.7	14	12	11.4	9.5	3.3
FYR Macedonia	2.5	1	8.1	12.8	5.1	2.6
Montenegro	31.9	25.6	39.6	43.1	25.6	21
Serbia	10.5	8.4	19.5	22	5.3	6.9
Net FDI (percent of GDP; share of total inflows in italics)						
	2005	2006	2007	2008	2009	2010
Albania	3.4	3.6	6.1	6.7	7.7	9.2
	88	*108*	*77*	*47*	*66*	*96*
Bosnia-Herzegovina	5.6	6.2	13.5	5	1.5	0.1
	44	*133*	*150*	*37*	*24*	*2*
Croatia	3.5	6.4	8	6.8	2.6	0.7
	33	*46*	*66*	*59*	*27*	*22*
FYR Macedonia	1.6	6.6	8.5	6.1	2	3.2
	62	*661*	*104*	*48*	*40*	*122*
Montenegro	21	21.7	20.8	17.9	30.8	17.9
	66	*85*	*53*	*41*	*120*	*86*
Serbia	6.1	14.5	6.4	5.6	4.7	3
	58	*174*	*33*	*25*	*90*	*44*
Net FDI (percent of the current account deficit)						
	2005	2006	2007	2008	2009	2010
Albania	56	64	59	44	57	78
Bosnia-Herzegovina	33	78	126	35	24	2
Croatia	67	97	111	77	50	68
FYR Macedonia	62	767	122	47	30	115
Montenegro	247	90	53	35	102	70
Serbia	71	143	40	26	67	41

Source: authors' calculation on IMF's *World Economic Outlook database* (September 2011).

Capital inflows were further attracted by deeper and increasingly competitive domestic financial markets, and by improvements in their regulatory and supervisory frameworks, usually stimulated in the context of Fund-supported programs. To an important degree, foreign capital was also drawned by progresses in structural reforms, including cuts in corporate tax rates (for example, in Albania and FYR Macedonia). Finally, abundant foreign capital was also attracted by expectations of stable (or appreciating) nominal exchange rates.

Between 2006 and 2008, capital inflows, as a ratio to GDP, increased by between 9 to 13 percentage points in Albania, Bosnia-Herzegovina, FYR Macedonia, and Serbia, and by close to 20 percentage points in Montenegro. They declined only modestly in Croatia, while remaining steadily robust at more than 11 percent of GDP. Capital flows were usually

dominated by FDI, which in turn were often related to privatizations[13], and were able to finance a substantial portion of the current account deficit.

Despite the general predominance of FDI, in some important cases external borrowing was also a significant component of capital inflows. For example, in Montenegro and Serbia FDI declined in 2007 and 2008, and capital inflows began to be dominated by external borrowing (IMF, 2008c). In Croatia, net FDI more than doubled between 2005 and 2007, but external borrowing increased rapidly as well (IMF, 2007b). To some extent, this was an inadvertent side effect of measures to rein in domestic credit growth, as corporates switched increasingly from domestic to external borrowing.

While generally substantial in quantitative terms, the qualitative impact of capital inflows on the medium-term external sustainability of the SEE-6 economies is less certain, as it is affected by the very nature of these inflows. In fact, capital inflows were dominated by "non-renewable" FDI, most notably sales of assets and privatization proceeds in the banking or telecom sectors[14], while "Greenfield" FDI[15] and portfolio flows were marginal (OECD, 2010; European Commission, 2010). As a result, rather than financing productivity-enhancing activities (which have a higher potential to raise the export capacity and generate future current account surpluses that, in turn, are needed to repay debt-creating capital inflows[16]), FDI fueled, to different degrees, consumption and the development of the non-tradable sector, feeding mostly into higher imports. As a result, current account deficits widened, and growth became unbalanced (IMF, 2010k, p. 44-45).

C. Rapid Credit Growth

Large capital inflows spurred strong credit growth in all SEE-6 countries through 2007 (Table 3). This was generally seen as a positive development, on account of these countries' lower degree (by regional standards) of financial deepening.

Credit expansion was primarily stimulated by the process of consolidation in the domestic banking systems led by the increasing presence of foreign banks. The latter provided capital and loanable funds to their local subsidiaries for them to increase domestic lending, and

[13] For example, in Bosnia-Herzegovina, FDI were behind the average of the region over 2004-06, but surged in 2007, most notably in the Republika Sprska, "*exclusively a result of successful completion of privatization contracts*" (CBBH, 2007b, p. 34). In the same vein, in FYR Macedonia FDI increased more than five-fold between 2005 and 2007 (to 8.5 percent of the GDP), boosted by institutional and tax reforms undertaken by the new government in that year. In Serbia, the sharp increase in FDI in 2006 reflects the privatization of Telekom Serbia.

[14] For example, in FYR Macedonia, more than half of FDI represented parent company loans, which increased external debt and were easier than Greenfield investment to reverse. In Montenegro, FDI represented about two thirds of total capital inflows, but were mostly directed to the recapitalization of the banking sector as well as to the real estate sector.

[15] Greenfield FDI contribute directly to gross fixed capital formation, expand the supply-side productive capacity, and help broaden the export base; and they are also relatively more stable, in terms of stocks, when compared to portfolio inflows, which can be highly volatile.

[16] External borrowing is a debt-creating flow that can negatively affect the income component of the current account balance.

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profit from the spread between domestic and foreign interest rates. Competition among banks for market shares became a driving force, as it induced banks to aggressively increase the credit supply and to reduce interest rates, which in turn boosted the demand for credit.

Table 3

Claims on Private Sector (percent of GDP)	2004	2005	2006	2007	2008	2009	2010
Albania	9.5	15.2	22.1	29.9	35.1	36.6	37.4
Bosnia-Herzegovina	36.9	43.7	47.9	54.3	57.8	57.3	57.8
Croatia	48.8	53.0	60.1	63.1	64.4	65.9	70.1
FYR Macedonia	21.5	24.0	29.0	35.3	42.1	43.5	45.3
Montenegro	14.6	17.9	36.3	80.2	86.9	76.4	68.6
Serbia	22.9	29.0	29.1	35.2	40.2	45.1	51.4
Private Credit/GDP growth rate (percent)							
Albania		60.4	45.5	35.3	17.4	4.3	2.4
Bosnia-Herzegovina		18.4	9.8	13.2	6.5	-0.9	1.0
Croatia		8.5	13.4	4.9	2.1	2.3	6.4
FYR Macedonia		11.7	20.5	22.0	19.0	3.5	4.1
Montenegro		22.8	102.2	121.2	8.3	-12.1	-10.2
Serbia		26.2	0.6	20.8	14.2	12.1	14.0

Source: authors' calculations on IMF's *International Financial Statistics* and *World Economic Outlook database* (September 2011).

Despite the benefits, the rapid pace of the credit expansion posed a string of risks to financial stability. For one, by moving down the credit spectrum, banks could take on bigger risks and underestimate the borrowers' creditworthiness, thus increasing the potential for a deterioration of asset quality in the event of a downturn. Furthermore, the heavy reliance on their foreign parents for loanable funds increased the exposure of domestic banks to funding risks, making them vulnerable to external developments.

Setting aside Montenegro, where the increase was exceptionally high due to country-specific circumstances[17], over 2004-08 the credit-to-GDP ratio grew by an average of 20 percentage points[18]. It grew particularly fast in Albania and FYR Macedonia, countries that in 2004 displayed lower degrees of financial deepening. By 2007, Fund staff estimated that in Croatia

[17] In Montenegro, credit to the private sector, increased from 18 to 80 percent of GDP between 2005 and 2007, reflecting a convergence play (IMF, 2009d). This expansion, which progressively replaced FDI as the main driver of domestic demand, was helped by the practice followed by public entities of placing deposits in commercial banks. In mid-2006, public entities accounted for 18 percent of total deposits and 15 percent of total loans.

[18] In Serbia a significant part of the domestic credit expansion did not involve the real sector of the economy, but rather represented a rise in claims on the central bank as a result of its measures to curb credit growth (European Commission, 2010, p. 19).

and Montenegro the stock of credit to the private sector, at close or above 70 percent of GDP, was exceeding the "equilibrium" level (IMF, 2008a; IMF, 2008f).

An important difference among the countries relates to the sources of funding. In fact, in Albania, FYR Macedonia, Montenegro (at least initially), and Serbia the credit expansion was funded by relying relatively more on domestic deposits rather than on cross-border credit lines[19]. In Montenegro this funding model was stimulated by the proceeds from privatization and assets (real estate) sales to non-residents, which fueled the pool of loanable funds.

However, in all of the countries rising external borrowing, notably by foreign-owned banks, played an important role in funding the domestic credit boom, as reflected in declining or increasingly negative net foreign assets (Table 4). In Bosnia-Herzegovina long-term borrowing by local subsidiaries from their foreign parents was the key factor underpinning the rapid credit growth. This was partly due to the tight regulatory requirements on maturity matching that limited the reliance on domestic deposits (IMF, 2007e).

Table 4

Net Foreign Assets (percent of GDP)

	2004	2005	2006	2007	2008	2009	2010
Albania	9.4	8.8	8.2	6.3	0.5	2.6	7.0
Bosnia-Herzegovina	-4.7	-8.5	-8.8	-7.4	-13.0	-11.6	-8.0
Croatia	-7.3	-11.9	-12.5	-5.9	-7.7	-9.3	-10.9
FYR Macedonia	9.7	7.9	7.1	4.0	0.0	0.4	-0.2
Montenegro	-1.1	2.3	-1.4	-17.0	-32.6	-23.9	-17.6
Serbia	-1.3	-7.4	-12.8	-8.3	-8.5	-12.4	-12.9

Source: authors' calculations on IMF's *International Financial Statistics* and *World Economic Outlook database* (September 2011).

D. THE BUILDUP OF EXTERNAL VULNERABILITIES

Robust growth and rapid credit expansion in the SEE-6 countries in the years leading up to the crisis were generally accompanied by the accumulation, to different degrees, of external vulnerabilities. They appeared in the form of deteriorating competitiveness, widening current account deficits, rising levels of external debt (particularly its private component), and balance-sheet exposure to exchange rate risk stemming from extensive euroization of the banking systems (Box 1).

Rising current account deficits and the rollover of maturing debt gave rise to large external financing needs, which in turn heightened these countries' exposures to shocks and contagion. In particular, risks to external stability were largely related to the possibility of "sudden stops" (or significant slowdowns) of capital inflows as well as to increases in the cost of foreign borrowing.

[19] In particular, in Albania in 2007 deposit represented more than 200 percent of total credit in the banking system (BoA, 2007, p. 40), while in FYR Macedonia, over the same period, they represented around 140 percent of total credit (NBRM, 2007, tab. 5, p. 13). In the same vein, in Serbia, 75 percent of total bank liabilities came from domestic sources in 2009 (NBS, 2009, p.41).

Box 1 - Monetary and Exchange Rate Policy Frameworks in the SEE-6 Countries

Extensive euroization constitutes a key common feature across the financial systems of the SEE-6 countries, something that may stand somewhat in contrast to the variety of monetary and exchange rate regimes displayed by these countries at the outset of the crisis.

Albania and Serbia were the only two SEE-6 countries with a floating exchange rate (respectively, the *lek* and the *dinar*, the latter being a managed float), in the context of an inflation targeting regime. In Albania, this monetary framework aims to keep inflation within a 3±1 percent target range, and the repo rate is the main policy instrument. Exchange rate flexibility was seen as appropriate in the face of Albania's exposure to potentially large idiosyncratic shock. Moreover, the avoidance of a significant misalignment of the currency was seen as a key benefit of the floating exchange rate (IMF, 2006f).

Serbia first adopted an inflation targeting regime as a new nominal anchor in September 2006, replacing the former exchange rate target. It aimed at a gradual transition towards a system with explicit objectives for "core" inflation (defined as retail prices excluding regulated prices and agriculture). In fact, in adopting the new regime, the National Bank of Serbia initially announced a core inflation "objective" range (7-9 percent for 2006, declining to 4-8 percent for 2007 and then to 3-6 percent for 2008 – NBS, 2006b; NBS, 2007), which would be only later redefined into formal "targets" once experience was gained.

At the other end of the specturm, Montenegro unilaterally adopted the euro as the sole legal tender in 2002, replacing the Deutsche mark, which was introduced as a parallel currency in 1999 and as sole legal tender in 2001.

The remaining three SEE-6 countries had fixed or quasi-fixed exchange rate arrangements.

In Bosnia-Herzegovina, a currency board regime had been in place since August 1997, with the convertible *marka* pegged to the Deutsche mark, and (from 2002) to the euro. FYR Macedonia introduced a *de facto* exchange rate peg of the *denar* to the Deustche mark in October 1995 (replacing a monetary targeting regime), and to the euro in January 2002 (IMF, 2005c). Since 1993, Croatia's *kuna* has been tightly managed, fluctuating within a narrowing band. The Croatian National Bank (CNB) geared monetary policy towards the stability of the *kuna*-euro exchange rate, which is the nominal anchor of the economy. In formal terms, this stability was the predominant operating objective of monetary policy, and standard monetary instruments, such as foreign exchange interventions and domestic liquidity management, are used primarily to achieve this goal. Although the CNB has avoided a formal commitment to a particular exchange rate level or band, it operated pragmatically, allowing moderate exchange rate fluctuations to accommodate seasonal market pressures.

One of the key characteristics of the fixed or quasi-fixed regimes in the SEE-6 countries is that they established a credible nominal anchor that generally delivered low inflation and well-anchored inflation expectations; equally importantly, these regimes enjoyed the broad support of the authorities and the public at large.

1. Widening Current Account Deficits and Deteriorating Competitiveness

As a result of large capital inflows, rapid credit expansions, and domestic demand booms, between 2006 and 2008 almost all SEE-6 countries suffered from a significant deterioration in their external balance (Table 5) and higher inflation in the non-tradable sector.

It is important to note that large and widening current account deficits seem to be specific to European transition economies, as these features do not generally apply to emerging market countries in Asia and Latin America that shared similarly fast growth rates in the 2000s (EBRD, 2009, p. 62)[20].

[20] At the same time, not all European transition economies displayed the recurrent association between domestically-driven fast growth and current account deterioration. For example, countries such as the Czech Republic, Poland, Slovenia, and Slovakia recorded slower but more export-led growth during the boom years,

(continued)

Table 5

Current Account Balance (percent of GDP)	2005	2006	2007	2008	2009	2010	2011
Albania	-6.1	-5.6	-10.4	-15.1	-13.5	-11.8	-10.9
Bosnia-Herzegovina	-17.1	-8.0	-10.7	-14.3	-6.2	-5.6	-6.2
Croatia	-5.3	-6.6	-7.2	-8.8	-5.2	-1.1	-1.8
FYR Macedonia	-2.5	-0.9	-7.0	-12.8	-6.7	-2.8	-5.5
Montenegro	-8.5	-24.1	-39.5	-50.6	-30.3	-25.6	-24.5
Serbia	-8.7	-10.2	-16.1	-21.6	-7.1	-7.2	-7.7

Source: authors' calculation on IMF's *World Economic Outlook database* (September 2011).

Setting aside the particular case of Montenegro, the deterioration in the external balance built on an already high deficit in Bosnia-Herzegovina and Serbia. In the latter, the current account deficit widened markedly before the crisis, by over 11 percentage points between 2006 and 2008, and stood at around 22 percent of GDP in 2008, one of the highest in the region.

Croatia sets itself apart, as its current account deficit widened the least (by slightly more than 2 percentage points only), while approaching 9 percent of GDP. The case of FYR Macedonia also stands out for the size and speed of the current account deterioration experienced between 2007 and 2008 (almost 6 percent of GDP), despite strong export growth and little real exchange rate movement, suggesting that lower private savings was the immediate cause (IMF, 2009b).

The general rise of external vulnerabilities as a result of factors common to the SEE-6 countries was compounded by some country-specific causes.

In Albania, the current account deficit tripled between 2006 and 2008 (to 15 percent of GDP), primarily on account of temporary factors, such as high imports of electricity and capital goods, and the scaling up of an import-intensive road project.These deficits mainly reflected an ambitious public investment program and were easiliy financed by FDI and high remittances (about 13 percent of GDP in 2007). While underlying trends looked sounder, there was awareness that lower current account deficits had to be achieved in order to improve government debt sustainability, particularly given the planned shift from concessional to market finance (IMF, 2008h; IMF, 2009c).

Unlike other countries in the region with rising external deficits, the increase in Serbia's external deficit had not primarily reflected a temporary demand boom but, with national savings declining, was instead mirroring high consumption relative to income levels. Exports (along with investment and employment) remained at comparatively low levels (Table 6), although they had increased by over 5 percentage points of GDP over 2005-08. Serbia's external imbalances thus stand out in terms of their root causes, as the factors underlying the

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which prevented the accumulation of sizable external imbalances (EBRD, 2009, p. 56). Like in other peer economies, in the SEE-6 countries the pressures from domestic demand on the external balance were usually exacerbated by delays in advancing structural reforms so as to boost these economies' growth potential, as these lags limited the supply-side response (notably a rise in export capacity) that was needed to foster external sustainability.

trade deficit were typically of a structural nature, notably low household savings rates, domestic supply rigidities, and delays in reforming weak corporate structures[21].

Table 6

Exports of Goods and Services (percent of GDP)						
	2005	2006	2007	2008	2009	2010
Albania	22.9	25.5	28.2	29.3	28.7	32.0
Bosnia-Herzegovina	32.6	36.5	37.4	37.0	32.3	37.7
Croatia	42.4	42.7	42.2	41.7	35.4	38.3
FYR Macedonia	42.8	45.5	50.9	50.3	37.9	45.9
Montenegro	43.5	49.4	44.4	39.5	32.1	36.5
Serbia	26.2	29.9	30.6	31.3	29.4	35.2

Source: authors' calculation on IMF's *World Economic Outlook database* (September 2011).

Similar to Serbia, in Croatia a persistent savings-investment gap since the mid-1990s had led to high current account deficits and a buildup of external debt. Despite that the objective of mitigating the country's external vulnerabilities had long featured high in the authorities' agenda, starting in 2005-06 a boom in consumption and investment translated into growing imports that widened the current account deficit to around 9 percent of GDP in 2008, twice as much as the level in 2004, while the external debt reached new peaks (IMF, 2008f).

In Bosnia-Herzegovina, macroeconomic imbalances started to emerge in 2007, as an absorption boom spilled over into a large current account deficit, which widened from 8 percent in 2006 to about 11 percent in 2007 (among the highest of the region), mitigated by a parallel jump in FDI. Buoyant domestic demand and a terms-of-trade deterioration led to a further widening of the current account deficit in 2008, to close to 15 percent. At the same time, FDI declined and their coverage of the current account deficit fell from more than 100 percent in 2007 to only 35 percent, prompting additional external borrowing by banks and a drawdown of official FX reserves.

FYR Macedonia differs from other SEE-6 countries, as its current account deficit had progressively fallen from about 8 percent in 2004 to close to balance by 2006, because of continued private transfers that offset a sizable trade deficit (around 20 percent of GDP). The current account widened back to a deficit of 13 percent of GDP in 2008, as a result of a shift to more expansionary policies in 2007 (including increases in public wages and pensions).

Montenegro is a unique instance among SEE-6 countries, with a current account deficit that exceeded 50 percent of GDP in 2008, the highest level among transition economies in

[21] As a testament to the structural nature of the problem, it is noticeable that Serbia's current account deficit, at 10 percent of GDP in 2006, had barely budged in the previous four years despite multiple macroprudential measures, intervention in the foreign exchange market to contain currency appreciation, and a fiscal consolidation of over 5 percentage points of GDP under the Fund-supported 2002-05 Extended Arrangement (IMF, 2006j). Weak governance (most notably in socially- and state-owned enterprises) was reflected in sizeable corporate losses of the non-financial sector, which drained domestic savings and laid at the core of Serbia's external deficits.

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Europe. As a small open and completely euroized economy, the current account deficit bore the brunt of the strong demand pressures that were spurred by a combination of FDI inflows and related credit expansion. The high savings-investment gap also reflected very low savings associated with wealth effects driven by soaring assets prices and the relaxation of liquidity constraints (IMF, 2008a; IMF, 2009d).

As far as competitiveness is concerned, signs of deterioration in the run-up to the crisis came into view mostly as a consequence of lax wage policies in the public sector, as well as of structural factors.

In Serbia signs of real exchange rate overvaluation appeared as early as 2006, but exports of goods were growing rapidly, although from a low base. The decline in competitiveness was ascribed to slow structural reforms, other than to excessive wage increases and loose fiscal policies (IMF 2008c). In Montenegro, competitiveness indicators did not provide clear evidence of overvaluation, but the scale and pace of the deterioration in the current account deficit pointed to eroding competitiveness that limited the diversification of the export base.

On the contrary, in Croatia external competitiveness appeared broadly adequate in 2006-08, but export performance, while improving, was relatively less dynamic. In fact, against most of the SEE-6 countries, where the exports-to-GDP ratio had been increasing, Croatia's export ratio had stagnated (Table 6). This lackluster export performance seemed to be largely due to some long-standing structural issues, notably the low attractiveness of the business environment.

In the same vein, competitiveness was not an issue in Albania and Bosnia-Herzegovina, as both countries, amid robust productivity gains in the tradable sector, displayed strong export growth along with steadily rising export market share (Bosnia-Herzegovina), and diversification in terms of both products and markets (Albania).

2. Rising External Debt

In 2008, external debt was generally high in almost all SEE-6 countries, and particularly elevated in Croatia, Montenegro, and, to a lesser extent, Serbia (Table 7), contributing to increasing the external financing requirements.

In Montenegro, public external debt was relatively low in 2006, at 25 percent of GDP, and declined further to 14 percent by 2008[22]. On the contrary, private external debt had been rising rapidly since 2006, almost doubling from 35 percent of GDP to 60 percent in 2008. In Croatia, external debt breached the 80 percent of GDP threshold in 2007, up by almost 15 percentage points since 2005.

[22] The country benefited from debt restructuring and write-offs by Paris Club creditors and bilateral donors in 2003 and 2006.

Table 7

External debt outstanding at year-end (percent of GDP)

	2005	2006	2007	2008	2009	2010
Albania	20.4	25.0	25.3	27.5	33.4	36.6
of which: official debt[1]	18.7	19.0	17.8	17.5	24.3	25.6
Bosnia-Herzegovina	50.7	47.9	49.5	48.9	54.9	56.9
of which: official debt[1]	24.0	22.1	19.6	17.2	22.5	26.0
Croatia	68.6	78.5	82.4	82.0	102.7	102.1
of which: official debt[1]	8.5	9.0	8.7	7.4	8.8	10.0
FYR Macedonia	50.0	50.4	50.7	45.5	59.1	59.0
of which: official debt[2]	26.6	22.5	16.2	12.6	17.6	16.2
Montenegro	43.9	59.8	84.4	75.2	97.8	100.2
of which: official debt[2]	28.4	24.7	18.3	14.4	24.6	30.6
Serbia	61.3	66.8	67.3	64.3	81.6	83.1
of which: official debt[1]	0.0	27.2	33.2	26.1	32.5	34.4

[1] Creditor-based. [2] Debtor-based.
Source: authors' calculation on IMF's *World Economic Outlook database* (September 2011).

In Albania external debt increased by 7 percentage points of GDP during 2005-08, although it remained by far the lowest in the group. Over the same years, external debt in Bosnia-Herzegovina and FYR Macedonia remained close to 50 percent of GDP. However, in both countries, the risks posed by external debt were mitigated by such features as long-term maturities and concessional terms[23].

While the public component was generally declining, a key feature of the dynamics of external debt is that it is largely accounted for by its private component, in turn mainly the result of a shift in the financing of the rising current account deficit from non-debt-creating FDI to external borrowing. In fact, the increase in Serbia's private external debt is mostly owed to increased direct cross-border borrowing by corporates[24]. In the same vein, in Croatia and Montenegro the accumulation of external debt was partly the result of higher intercompany loans, notably borrowing by foreign-owned domestic subsidiaries from their parent banks.

In this regard, it is important to underscore that parent bank-to-subsidiary loans can increase a country's ability to retain access to external financing in times of crises[25] and can mitigate

[23] In FYR Macedonia, a strengthening of the current account, which was close to balance in 2006, translated into a doubling of international reserves, which jumped from €700 million at end-2004 to €1.2 billion in May 2006 (IMF, 2006g). Along with the country's improved access to international capital markets, this allowed the authorities to reach an agreement in January to prepay €78 million in Paris Club debt, and to make an advance repayment of its entire outstanding obligations to the Fund in May 2007, while continuing with the 2005 Stand-By Arrangement.

[24] See Section III.B.

[25] For example, in Croatia, during the peak of the crisis, banks were able to continue borrowing from abroad, which resulted in an increase of their external debt (Jankov, 2009).

the risk of sudden stops of capital inflows. In particular, foreign banks' commitments to maintaining (or increasing) the exposures to their domestic subsidiaries can *de facto* boost a country's foreign exchange reserves and complement the central bank as lenders of last resort (IMF, 2011f)[26].

3. Euroization and FX-Related Credit Risk

All SEE-6 countries featured a high degree of euroization of their banking systems' assets and liabilities. For example, in 2008, lending in (or linked to) foreign currency (FX lending), as a percentage of total loans to the private sector, ranged from 50-60 percent in FYR Macedonia to 80-90 percent in Croatia.

The increase in the share of FX-lending is generally accounted for by their lower interest rates if compared with those charged on domestic borrowing. In turn, this interest rate differential may be linked to the dominant presence of foreign banks and their availability of funding in foreign currency (EBRD, 2009, p. 71)[27]. Moreover, in some countries euroization of the banks' assets also reflected a high share of foreign currency deposits in total liabilities. As recognized by a few authorities themselves, the limited flexibility of some exchange rates was deemed to be conducive to borrowing in foreign currency[28].

Since a large share of loans flew to the non-tradable sector, which generally had no financial or natural hedges[29], euroization exposed domestic borrowers' balance sheets, to various degrees, to currency risks arising from a depreciation of the national currency. At the same time, since euroization usually applied not only to financial liabilities but also to financial assets, in some cases the exposure to currency risk was less significant in the aggregate, given an overall balanced net open position. However, mismatches at the individual level between borrowers and depositors remained a concrete possibility. While banks could be covered against direct foreign exchange rate risk, they remained exposed to indirect currency risk, since their debtors were usually unhedged.

Moreover, it is important to underscore that high euroization constrained the ability of national central banks to act as lenders of last resort and to support financial stability, as this

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[26] In commenting on the decline in official reserve in late-2008, the Croatian National Bank noted that "*as foreign parent banks have already expressed willingness to provide additional emergency liquidity support to leading Croatian subsidiaries, the end-2008 reserves level should be sufficient to mitigate the impact of a possible prolonged halt in capital inflows in 2009*" (CNB, 2008, p. 8).

[27] The 2005 FSSA Report on Albania (IMF, 2005e, p. 10), in explaining the large prevalence (above 80 percent of total loans) of loans denominated in foreign currency, points to some banks reporting that "*borrowers simply note that interest rates applied to foreign currency-denominated loans are lower than in* lek *and ignore the foreign exchange risk they are assuming despite information about risks provided by the banks*".

[28] However, opposite views also exist. For example, in the opinion of the CNB, a stable exchange rate, in combination with other monetary and prudential measures, contributed to a gradual and significant reduction in the level of euroization in the pre-crisis period (CNB, 2011).

[29] For example, at end-2008, in Croatia only about 5 percent of household debt and 9 percent of corporate loans in foreign currency were hedged.

function was limited by the level of foreign currency reserves, while the bulk of commercial banks' liabilities was in foreign currency (Bokan *et al*, 2009).

E. The State of the Financial Sector

As documented in the previous paragraph, in the run-up to the crisis a high degree of euroization, elevated external debt, and robust credit growth tested the banks' capacities to underwrite loans prudently and maintain adequate capital and liquidity buffers. More generally, these factors increased the vulnerabilities of the SEE-6 countries' financial systems to exchange rate and credit risks, and posed supervisory challenges.

This notwithstanding, a crucial common feature of the SEE-6 countries' financial systems was that they remained broadly healthy at the outset of the crisis, even if one recognizes that banks' balance sheets (most notably, nonperforming loans) at the peak of the business cycle may to some degree underestimate credit risks[30]. The resilience of these financial systems and the adequacy of their regulatory and supervisory frameworks had been enhanced through the implementation of many of the recommendations that followed the FSAP exercises conducted in all of the countries between 2005 and 2008[31]. FSAP exercises concluded that financial systems were generally sound, with banks well-capitalized, liquid, and profitable[32].

In particular, strengthened prudential regulation, proactive banking supervision, and prudent risk management helped build up capital buffers that in 2007 were comfortably above regulatory minimum standards, ranging from 17 percent in Croatia to 28 percent in Serbia.. As banking systems were predominantly foreign-owned by Western European banks, cooperation with parent banks' authorities had been intensified.

The perimeter of supervision was also broadened beyond the banking sector[33], partly in light of the fact that prudential measures applied to banks, as a side effect, tended to divert borrowing to non-bank channels and to induce corporates to borrow abroad directly.

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[30] Section IV.D discusses the deterioration of banks' financial soundness indicators in the aftermath of the crisis.

[31] In particular, Albania conducted an FSAP exercise in 2005 (IMF, 2005e), Serbia and Bosnia-Herzegovina in 2006 (IMF, 2006c, and IMF, 2006k, respectively); Montenegro in 2007 (IMF, 2008b); Croatia, and FYR Macedonia undertook an FSAP update in 2008 (IMF, 2008g and IMF, 2009b, respectively).

[32] In particular, the 2005 FSSA report praised the considerable strengthening of banking supervision in Albania (IMF, 2005e), while the 2008 FSSA update for Croatia noted substantial progresses in strengthening the regulatory and supervisory frameworks (IMF, 2008g). In Serbia, the 2006 Article IV Report noted that bank soundness was preserved, *inter alia*, through rigorous risk classification rules and high provisioning (IMF, 2006j). In Bosnia-Herzegovina, stress tests based on end-2006 data suggested that the banking system could absorb losses from asset quality deterioration, and that it was resilient to risks of slowing capital inflows. Banks were nonetheless encouraged to strengthen their capital positions, especially given their reliance on external borrowing (IMF, 2008i).

[33] For example, in Croatia a new supervisory agency (HANFA) was established, while in Albania all non-bank supervisory institutions were unified into a Financial Supervisory Authority. In Bosnia-Herzegovina, the mandate of bank supervisors was extended to leasing companies.

FSAP exercises were also instrumental in highlighting rising risks to financial stability in the run-up to the crisis. A common call was the need to carefully watch the risks posed by rapid credit growth, which in a few cases had lowered banks' capital adequacy and liquidity ratios, and raised concerns that credit risk was not measured appropriately, nor managed adequately[34].

With a view to helping mitigate vulnerabilities arising from rapid credit growth and improving banks' risk management, in Albania and Croatia a new credit bureau was established, while in Bosnia-Herzegovina the existing one was extended to individuals[35].

The exposure of domestic borrowers (especially households) to exchange rate risk associated with high loan euroization and the attendant indirect credit risk for banks were also repeatedly emphasized by both FSAPs and financial stability reports of the SEE-6 central banks[36].

On the liability side, as previously noted, domestic banks became increasingly dependent on funding from their Western European parents, making them vulnerable to external development and contagion risks, which materialized following the Lehman Brothers bankruptcy in September 2008.

Monitoring nonperforming loans (NPLs) was one of the key recommended actions to safeguarding financial stability. In Albania and Montenegro, NPLs more than doubled between 2006 and 2008, to around 6-7 percent of total loans; on the contrary, they were declining (at different paces) in Croatia and (above all) FYR Macedonia, respectively to 4.9 percent and 6.7 percent in 2008. In Bosnia-Herzegovina, the NPL ratio was the lowest in the group, at around 3 percent in 2008.

Another common feature of the financial systems in the SEE-6 countries was the decline in bank profitability as a result of narrowing interest margins under growing competition for market shares (and, in some cases, because of higher reserve requirements). Intense competition among banks, driven by ambitious market share or profitability targets, also raised concerns over a possible deterioration of asset quality, especially in the event of a downturn.

Despite the overall progresses, the SEE-6 countries' banking systems faced remaining weaknesses. In general, improving banking supervision to ensure that risk management

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[34] For instance, the 2007 FSSA warned that the main vulnerabilities in Montenegro's financial system were associated with the extremely rapid growth of the banking system, with liquidity and credit risk the greater sources of concern (IMF, 2008b). It was also underscored that financial soundness indicators were rapidly deteriorating: for example, the capital adequacy ratio declined from 21 percent in 2006 to 15 percent in 2008 (IMF, 2009d).

[35] In particular, in Albania the credit bureau was established in 2007 within the Bank of Albania, a measure that had been identified by the 2005 FSSA as a key short-term step to increase the availability and to improve the pricing of credit to small- and medium-sized enterprises (IMF, 2008e).

[36] As a ratio to GDP, in Croatia euro-denominated household debt to banks was almost twice as high as in the new EU member states, but deposits were comparatively higher (CNB, 2007a). The same applies to Bosnia-Herzegovina, where household debt was "*far above*" the average of the region (CBBH, 2007a). In contrast, the evolution, rather than the level, of household debt was a source of risk in Serbia (NBS, 2007).

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policies and underwriting standards remained high was a priority in all SEE-6 countries, particularly where there were emerging signs of deteriorating profitability in 2008.

For example, in Bosnia-Herzegovina capital adequacy ratios were declining and rising inflation was raising concerns about the ability of households and corporates to serve their debts. A series of new regulations to mitigate liquidity, market and operational risks was introduced in 2007. However, regulation that created a bias in favor of bank borrowing from abroad (and a link with credit expansion) remained in place. While the deterioration of the global financial landscape put a premium on intensified financial sector surveillance and preemptive measures, the fragmentation of bank supervision into two Entity-based agencies was singled out as a notable weakness in the case of Bosnia-Herzegovina (IMF, 2008i).

In Montenegro, an assessment of the Basel Core Principles for Effective Banking Supervision, while underscoring an overall satisfactory degree of compliance, highlighted significant weaknesses in banks' internal controls, as well as untested and under-resourced risk management processes (IMF, 2008b). More worrisomely, supervisors lacked effective enforcement powers, as the banking law did not give them sufficient room for maneuver to impose remedial measures on banks under administration without prior approval by shareholders, or to impose penalties without first obtaining court approval. In order to address the prudential aspects of rapid credit growth, the FSSA recommended a multipronged strategy that would rely on actions by banks, supervisors, and the legislative branch. In particular, banks should strengthen their internal processes. In light of the absence of a lender-of-last-resort facility, a further tightening of liquidity asset requirements was in order (IMF, 2008b).

When global financial conditions started deteriorating in 2008, stepping-up work on contingency planning for crisis management was one of the paramount measures in Albania, Croatia, and Serbia. In this context, strengthening cross-border cooperation with home-country supervisors of resident foreign banks was a key priority, and Memoranda of Understandings were often signed between the SEE-6 central banks and foreign parent-bank supervisors.

III. Pre-Crisis Policy Responses to Capital Inflows and Rising Vulnerabilities

Robust capital inflows and fast credit growth in the run-up to the global crisis posed relevant and multifaceted challenges to macroeconomic management in the SEE-6 countries. In this context, all national central banks undertook, to different degrees, an array of policies in order to contain not only domestic demand pressures and inflation risks[37], but also rising external vulnerabilities and risks to financial stability.

In general, the conduct of monetary policy, through the standard interest rate instrument, as the first line of defense against increased external borrowing and excessive credit growth was

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[37] Inflationary concerns from rapid credit growth at the domestic level and other country-specific factors were at times compounded by international cost-push factors, notably related to the global food and energy price shocks experienced in 2007-08.

usually very constrained in countries with a fixed or quasi-fixed exchange rate regime. In contrast, the flexible exchange rate regime in place in Albania and Serbia offered more scope for the use of monetary policy to contain credit growth; however, the effectiveness of the monetary instrument was limited by the extensive degree of euroization that characterized these countries' banking systems, which weakened the traditional monetary transmission mechanism through the interest rate. In this context, an interest rate increase had limited direct impact on credit growth, while it worked primarily through the exchange rate channel, given high pass-through rates, with the largest and most immediate impact on prices in the tradable sector.

As an important corollary of the various institutional and operational constraints faced by monetary policy, macroprudential policies, i.e., prudential and regulatory measures (most notably, reserve requirements) adopted with a macro-prudential orientation, came to play a crucial role in all SEE-6 countries in addressing external and financial risks, as a complement to (or substitute of) the use of the interest rate to influence credit aggregates.

On the contrary, fiscal policy generally failed to play a complementary or supplementary role in ensuring macroeconomic stability, most strikingly in countries where the fiscal instrument was the only available macroeconomic tool. In fact, in Bosnia-Herzegovina, FYR Macedonia, Montenegro, and Serbia, expansionary (and procyclical) fiscal policies adopted in 2006-07 compounded the risks to external stability posed by widening current account deficits.

A. Monetary Policy

To address rising inflation risks posed by rapid credit growth, the central banks of Albania and Serbia started a cycle of monetary tigthening in late-2005 and mid-2006, respectively.

In July 2006, ending a neutral stance followed over the previous year and a half that had been supported by a restrictive fiscal stance (IMF, 2006f), the Bank of Albania (BoA) started to increase the policy interest rate, with a further hike in November. This move, complemented by fiscal and prudential measures, was also meant to counter a widening current account deficit.

Following the tightening of the policy mix, private credit growth (on an annual basis) declined from about 75 percent at end-2005 to about 50 percent by end-2006 (IMF, 2007a); inflation picked up, but remained within the 3±1 percent target range[38].

In mid-2007, credit growth once again turned out faster than expected and headline inflation exceeded the target band for several months, pushed up by power disruptions and sharply higher world food prices (IMF, 2007c). To stave off second-round effects and keep inflation expectations firmly anchored, the BoA continued its tightening cycle by raising the policy rate to 6.25 percent in three half percentage point increases in June, September, and November 2007. As a result, by December 2007 headline inflation had declined back to 3

[38] Low and relatively stable headline inflation masked a steady pickup in non-tradable inflation, indicating emerging capacity constraints in the non-tradable sector since mid-2005 as a result of a boom in domestic demand (IMF, 2006f).

percent; by mid-2008 credit growth had slowed down, while the stock of credit had approached levels observed in other countries in the region.

The case of Serbia is a noteworthy example of the fact that the ability of monetary policy to contain rapid domestic credit growth (although from a very low base) resulting from large capital inflows can be limited even in the presence of supportive fiscal and macroprudential policies. In fact, before the adoption of an inflation targeting regime in August 2006[39], bank lending to corporate and household sectors recorded high growth rates (close to 60 percent in 2005), despite fiscal consolidation of over 5 percentage points during 2002-05 and a string of macroprudential measures (IMF, 2006j).

As the actual inflation rate was trending above the value initially projected for the year, the National Bank of Serbia (NBS) undertook significant monetary tightening through a combination of an active use of the interest rate, stepped-up repo operations, and changes in reserve requirements (the introduction of a differentiated reserve requirement ratio and an increased reserve base)[40]. After reaching the lowest level (about 14 percent) in August 2005, the repo rate started to rise in late 2005, with a cumulative 600 basis point increase between November 2005 and April 2006 (to around 22 percent).

However, faced with the excessive sterilization costs associated with the monetary tightening adopted to counter strong capital inflows, in February 2006 the NBS took steps to increase exchange rate flexibility, anticipating an eventual float[41]. The appreciation of the dinar, subsequent to the policy change, signaled a positive market reaction and proved effective in reducing inflation given a high exchange rate pass-through[42].

In August 2006, the NBS adopted a new monetary policy framework, which involved a numerical objective for core inflation (within the range of 7-9 percent for 2006) and the use of the repo rate as the main monetary policy instrument to manage bank liquidity. The new

[39] Before 2006, the conduct of monetary policy was indeed complicated by the use of the exchange rate as the system's nominal anchor. The exchange rate regime in place since 2001, a managed floating with limited flexibility, allowed a slow nominal depreciation of the dinar, despite pressures toward appreciation from large capital inflows. The practice of countering the appreciation of the exchange rate in the face of strong capital inflows complicated monetary management, as it required interventions in the foreign exchange market that resulted in a boost to liquidity. This regime reflected a trade-off between inflation and current account objectives: while contributing to reducing inflation, it posed risks for the external balance by favoring a real appreciation of the currency (IMF, 2006c).

[40] Price developments prompted the NBS to improve its operational toolkit and to increase the use of market-based instruments to reduce excess liquidity in the banking sector. In January 2005, the NBS started holding repo auction sales of securities, and outright sales of long-term government bonds were introduced in August. Moreover, since September 2005, the 14-day repo rate had become the key policy rate (despite that the Law on Banks prescribes that the discount rate is the reference rate), with a view to strengthening its impact on bank lending and deposit rates via the interest rates in the interbank market. However, the increase in repo operations and outright sales of NBS securities proved to be insufficient to sterilize the excess liquidity, as nominal interest rates declined through August and became negative in real terms.

[41] The NBS started pursuing a soft-managed floating foreign exchange regime, retaining the right to intervene in the foreign exchange market in the event of excessive daily exchange rate fluctuations, threats to financial and price stability, and risk to the adequacy of the level of foreign exchange reserves (NBS, 2008, p. 18).

[42] Close to unity within a year for core inflation (IMF, 2006j, p. 8).

monetary policy framework proved to be successful in achieving a decline in both inflation and inflation expectations. As a result of this tighter stance, core inflation declined from 14.5 per cent at end-2005 to 6 percent at end-2006, and remained well within the target range. In the course of 2006, in parallel with the decline of inflation, the repo rate (initially set at 18 percent) was progressively reduced by four percentage points in the last quarter (NBS, 2006a).

In the course of 2007, the degree of monetary policy tightness was adjusted in line with movements in inflation and inflation expectations. During the first half of the year, while inflation was below the lower bound of the target range, the key policy rate was further (and gradually) lowered, from 14 percent at end-December 2006 to 9.5 percent in June 2007[43].

This notwithstanding, the overall monetary stance remained restrictive, partly as a response to the adoption of expansionary fiscal and wage policies in 2006, which complicated the disinflationary goal by compounding the pressure on prices arising from shocks to global food and energy prices. On the other side, large capital inflows caused a sharp nominal appreciation of the dinar through late-October 2007 that complemented the disinflationary effort[44]. Eventually, at the end of 2007 core inflation had remained within the 4-8 percent target range (headline inflation exceeded 10 percent, reflecting rising energy and utility prices).

At the end of 2007, the easing cycle was reversed and the NBS started increasing the policy rate in the face of heightened inflationary pressures, triggered by a drought-related spike in domestic food prices (the "agricultural shock") and hikes in world oil prices. In an effort to contain second-round effects from supply shocks as well as exchange rate depreciation, the NBS hiked its policy interest rate six times between February and November 2008, by a cumulative 775 basis points (to 17.75 percent).

While this tight monetary policy managed to lessen inflationary pressures, the effects of agricultural and oil price shocks were strong enough to make core inflation exceed 10 percent, well above the end-2008 target range of 3-6 percent. This outcome stands in contrast with the situation in Albania, where a broadly similar monetary and exchange rate framework allowed the country to weather well the global energy and food price shock of 2008 (despite being a net importer of both), and inflation expectations remained well-anchored.

In the case of Serbia, the lower effectiveness of monetary policy to contain price pressures partly owes to some structural features of the economy, where inflation was the highest in the region and inflation expectations were high and well-entrenched; at the same time, it was also the result of a markedly expansionary fiscal policy in the last quarter of the year (NBS,

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[43] At the same time, to mop up excess liquidity in the banking system, the volume of NBS securities sold in the year (mostly through repo auctions) was three and a half times as much as its volume in 2006. (NBS, 2007, p. 25).

[44] The NBS actively participated both ways in the foreign exchange market in 2006-07, accommodating foreign inflows via purchases at a premium from foreign exchange bureaus, and occasionally intervening to prevent excessive depreciation. The purchases, combined with privatization receipts, inflows into NBS securities, and private credit flows, boosted official reserves to over 7.5 months of imports by end-November 2007. Direct intervention diminished in 2007 and was limited to smoothing shocks (IMF, 2008c).

2008, p. 20), with a substantial increase in transfers to households (including wage settlements that exceeded inflation plus labor productivity growth).

The monetary tightening cycle ended in the face of a deceleration of growth since the third quarter of 2008, as a result of deteriorating external conditions and the prospective policy shift to targeting headline rather than core inflation.

Contrary to the cases of Albania and Serbia, in Croatia and FYR Macedonia the conduct of monetary policy through standard instruments was constrained by the objective of preserving the fixed or quasi-fixed exchange rate regimes. As a result, the use of the policy interest rate to tighten monetary conditions was inevitably much more limited, and macroprudential measures usually took over as the primary tools to manage monetary and credit aggregates.

In Croatia, the Croatian National Bank (CNB)'s policy rate (the repo rate) remained relatively unchanged through end-2007[45], as monetary policy, in the context of a very open capital account, was primarily focused on supporting the stability of the exchange rate, although it also aimed to stabilize the external debt-to-GDP ratio[46]. As noted in paragraph II.D.2, this ratio had increased by 20 percentage points (to over 80 percent) between 2002 and 2004, causing the focus of the CNB policy to shift toward restraining external debt.

In FYR Macedonia, in January 2004 the National Bank of the Republic of Macedonia (NBRM) had started to increase the interest rate on its bills (from 6.15 percent in December 2003 to 10 percent in April 2005), which prompted higher lending rates. These increases proved nonetheless to be fairly ineffective in dampening the credit boom that had begun in 2002, partly because a large portion of lending was in foreign currency (IMF, 2005f).

It is important to note that changes in the NBRM policy rate became strictly subordinated to the strength of the external position and the level and trend of foreign exchange reserves (the overriding factor). Following a sound macroeconomic performance (including prudent fiscal policy) and favorable developments in the foreign exchange market during the year, in October 2005 the NBRM changed its main monetary policy instrument by shifting the auctions of its bills from a "volume tender" procedure to an "interest rate tender" procedure, which assumes a market-based setting of the interest rates (NBRM, 2005, p. 37). In the face of strong capital inflows that increased gross reserves by 6 percent of GDP between 2005 and 2007, the NBRM started an easing cycle, and interest rates on its own bills were cut significantly, from 10 percent in September 2005 to a minimum of about 4.7 percent in November 2007.

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[45] In 2005, the CNB introduced open market operations, in the form of weekly reverse repo auctions (with treasury bills as collateral), to improve its monetary policy instruments and the ability to manage the liquidity of the banking system. Prior to the introduction of reverse repos, the main instrument for creating liquidity was through purchases of foreign exchange at auctions.

[46] While tight monetary conditions aimed to avoid excessive credit expansion and to control the current account deficit, the central bank also managed liquidity with a view to preventing excessive appreciation pressures and to facilitating domestic financing of the budget deficit (CNB, 2006, p. 9). As part of this strategy, in November 2004 the reserve requirement rate was cut from 19 percent to 18 percent and the minimum required amount of foreign currency claims was cut from 35 to 32 percent in February 2005 (CNB, 2004, p. 11).

In early-2008, the NBRM reversed its stance and started tightening monetary policy in response to higher inflationary pressures from world food and energy prices, a deterioration of the current account deficit, and lower net inflows of capital. Importantly, the NBRM switched back to a volume tender procedure to increase the signaling role of its policy rate, and gradually raised central bank rates to 7 percent (IMF, 2009b).

B. The Use of Macroprudential Measures

As noted before, as a major consequence of the limitations faced by monetary policy, macroprudential measures were extensively employed by all SEE-6 countries to address inflation and financial stability risks[47].

Given extensive euroization and balance sheet risks, one of the key objectives of macroprudential measures was to mitigate the credit risk related to foreign currency lending and, in the process, moderate credit growth to the private sector. Reserve requirements for commercial banks were the most used form of macroprudential measures, applied to bank liabilities in both domestic and foreign currency.

The use of macroprudential measures intensified in parallel with the acceleration of the process of domestic credit creation. Some central banks felt that while they could do little to target and control overall credit growth, they could influence its quality by means of prudential regulation.

In Albania and Serbia, macroprudential measures were adopted to complement monetary policy, while in the other countries these measures played more a role of substitutes for an independent monetary policy, owing to the virtual unavailability of the interest rate instrument. A key common feature of the macroprudential measures employed by the central banks in Croatia and Serbia was their goal of containing the surge in external borrowing, most notably that on the part of foreign-owned subsidiaries which drew on their parent banks to fund their domestic lending activity.

In Albania, important prudential and supervisory measures were introduced starting in mid-2006, with a focus on voluntary compliance[48]. These measures aimed at increasing the effective cost of lending while improving credit risk management and maintaining loan quality[49]. The most important among such measures, introduced in January 2007, was to

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[47] Lim *et al* (2011) provides a comprehensive empirical study of the effectiveness of macroprudential instruments to date.

[48] In the words of the BoA's Governor, the decisions made before the crisis in the area of monetary policy and banking supervision have constituted an "*immunity platform*" that has contributed, along with the decisions adopted since autumn 2008 (the "*crisis absorption platform*"), to the resilience showed through the crisis by the Albanian economy and its financial system (Fullani, 2009).

[49] To increase the costs of financial intermediation, amendments to regulations included: increasing reserve requirements on foreign-currency deposits (from 10 percent); imposing minimum capital adequacy requirements higher than the standard 12 percent on high-risk banks identified by the banking supervisor; raising the maximum risk weights applied to high-risk loans to 150 percent; and requiring higher provisioning on classified loans (IMF, 2006f).

mandate stricter requirements on individual banks based on twin limits related to: the rate of credit growth, and the level of nonperforming loans.

In Serbia, before the adoption of a new monetary framework in August 2006, reserve requirements made up the bulk of the monetary tightening in 2005, accounting for 90 percent of the total reduction of liquidity (12 percent of GDP - NBS, 2006a). In the new monetary framework as well, the NBS continued to use macroprudential regulation to slow the rapid pace of domestic credit growth, particularly to households in foreign currencies, and tightened measures were introduced at end-2006 and in the second half of 2007 (NBS, 2007).

The use of macroprudential measures to address vulnerabilities in the financial sector played the most critical role in the case of Croatia. The CNB made extensive use of prudential and supervisory instruments as early as 2003 to address a credit boom that started in 2001-02. Further measures were taken in the context of the 2004-06 SBA, so as to complement fiscal and quasi-fiscal adjustments in pursuing external stability. The most significant of such measures, introduced in July 2004 on a permanent basis, was the marginal reserve requirement (MRR) on the increase in banks' foreign liabilities, which became one of the key monetary policy instruments of the CNB[50]. Importantly, the MRR marked a change in the focus of the central bank's policy from restraining credit growth to containing foreign borrowing and external debt (CNB, 2004, p. 9).

Prudential measures were further tightened in 2006 to address a pick-up in FX credit to households since mid-2005, which increased banks' exposures to indirect exchange rate risk. A key characteristic of these new measures was their goal of integrating currency-induced credit risk into prudential regulations (IMF, 2006h). To this end, capital-adequacy risk weights were raised on foreign currency loans to unhedged borrowers, and the base of the foreign-exchange liquidity requirement was broadened to cover instruments indexed or denominated in foreign currency[51].

In Montenegro, between September 2007 and January 2008, the central bank introduced higher effective reserve requirements and stricter prudential provisions to increase the banks' capitalization, and to improve their credit and liquidity risk management[52]. These measures tried to address a rise in nonperforming loans, a reflection of the fact that increased competition among banks came at the expense of loan quality. With the same objective of safeguarding bank soundness, at end-2007 the Central Bank of Bosnia-Herzegovina (CBBH)

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[50] The MRR (initially set at 24 percent) required an unremunerated foreign currency deposit at the CNB related to the increase in banks' foreign liabilities from June 2004. The MRR was raised repeatedly, while simultaneously reducing the general reserve requirement from very high levels, in order to facilitate the government's efforts to shift budget financing to domestic sources. Effective January 2006, the MRR was increased to 55 percent, and in February was complemented by a second-tier requirement, also set at 55 percent. The new MRR applied to a broader base which included corporate borrowing from abroad guaranteed by Croatian banks, as well as banks' borrowing from domestic leasing companies (IMF, 2006d).

[51] It has been estimated that, as a combined effect of these prudential measures, banks were required to hold 72 percent of the increase in foreign liabilities with the central bank or in liquid foreign assets (Jankov, 2009).

[52] As a follow-up to the 2007 FSAP recommendations, the minimum solvency ratio was raised from 8 percent to 10 percent and a new Banking Law allowed the Central Bank to ask for an even higher ratio if warranted by the risk profile of the bank (IMF, 2009d).

increased reserve requirements (from 15 to 18 percents) to counter an acceleration of credit expansion.

In FYR Macedonia, the objective of reducing risks to bank balance sheets and of protecting the quality of their loan portfolios was primarily pursued through a strengthening of bank supervision, in the context of the August 2005 Fund-supported program (IMF, 2005f)[53].

Despite the widespread use of macroprudential measures by the SEE-6 central banks, the evidence of their ability to contain credit growth is mixed at best.

In Croatia and Serbia, credit growth remained robust even though prudential measures were tightened in 2006 and 2007, respectively. In Montenegro, the increase in the cost of credit through higher reserve requirements hardly dented bank lending, given the exceptional pace of credit growth (peaking at an annual rate of 180 percent in 2007) and the structural limits posed by euroization on controlling credit aggregates.

The effectiveness of macroprudential measures was often hamstrung by increased competition among banks to acquire market shares, or by the banks' actions to circumvent the measures. In Croatia, banks were able to continue funding strong domestic lending by means of large recapitalizations and retained earnings, coupled with a sharply higher recourse to domestic funding. As a result, between end-2005 and end-2006 the annual growth rate of bank loans rose from 17 to 23 percent. On the positive side, the share of FX lending had declined since 2006 (IMF, 2008f), partly as a reflection of the MRR. In Serbia, total lending to domestic enterprises and households rose by close to 40 percent in 2007, as competition in the banking sector intensified (NBS, 2007).

The above examples also highlight that the use of reserve requirements was not without side effects, including the possibility of stimulating regulatory arbitrage. In fact, while the increase in reserve requirements on foreign borrowing led to a slowdown of domestic credit to enterprises, domestic banks engaged in circumventing these requirements and in letting their foreign parents provide cross-border loans directly to Croatian and Serbian companies (NBS, 2009; Jankov, 2009)[54].

As a result of these limitations, some countries (Croatia in 2003 and 2007, FYR Macedonia and Montenegro in 2008) introduced direct credit controls, although on a temporary basis[55].

In Croatia, credit ceilings and additional liquidity requirements were first adopted in 2003[56] in an attempt to slow down credit growth, which proved to be largely unsuccessful (IMF,

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[53] However, balance sheet risks remained overall small, given the improved quality of banks' loan portfolios, and widespread natural hedges such as large inflows of remittances to households. Moreover, the foreign asset position of the NBRM was able to cover all *denar* deposits.

[54] Serbia thus became one of the largest recipients of cross-border loans in the region. Corporates' foreign debt grew by over 350 percent between 2005 and 2008 (NBS, 2009, p. 31). As a share of total credit to the non-bank private sector, foreign loans increased from less than 20 percent in 2005 to over 35 percent in September 2008, one-third of which was guaranteed by domestic banks.

[55] The potentially negative side effects (including on credit to smaller enterprises and bank competition, and the risk of pushing credit outside domestic banks) were well recognized. Fund staff recommended replacing quantitative controls when they expired with higher reserve requirements and capital requirements for riskier loans.

2004). Direct credit controls were reintroduced[57] on the banks' asset side in 2007 (later extended to 2008), once again as a response to the limited ability of the prudential measures adopted in 2006 to effectively curb credit growth. It is noticeable that these measures were partly taken with a view to offsetting an election-related loosening of the fiscal stance and off-budget fiscal spending, notably "pensioners' debt" repayments of 1.2 percent of GDP (IMF 2008f, p.10).

In Montenegro, temporary bank-by-bank credit ceilings (ranging from 30 percent to 60 percent) were introduced in January 2008, while in FYR Macedonia quantitative credit controls were adopted in June 2008, requiring banks to place low-interest deposits if their household credit growth was set to exceed 40 percent by the end of the year.

Similar to the previous cases of other prudential measures, the evidence on the effectiveness of direct credit controls is far from conclusive. In Croatia, the direct credit controls introduced in early 2003 were followed by a sharp decline in the growth rate of bank lending (from 33 percent in 2002 to 11 percent in 2003), but the expansion of total credit (which included leasing and foreign borrowing) decelerated by much less (from 26 to 18 percent). In the same vein, following the reintroduction of direct credit controls in 2007, the growth rate of bank loans slowed from 23 percent in 2006 to 15 percent at the end of 2007 (CNB, 2007b, p. 38). However, while bank lending to the corporate sector declined considerably, total credit growth to the private sector (from external sources, and domestic banks and nonbanks) slowed only modestly (IMF, 2008f).

In FYR Macedonia, the effectiveness of quantitative controls was undermined by the banks' race for market share, since many of them preferred to pay the penalty of compulsory low interest rate deposits in order to continue extending credit.

C. Fiscal Policy

Given the constraints on the use of monetary policy and the limited effectiveness of macroprudential measures, fiscal policy was a key tool for ensuring macroeconomic stability in the SEE-6 countries, most notably in those with fixed or quasi-fixed exchange rate regimes (Bosnia-Herzegovina, Croatia, FYR Macedonia, and Montenegro).

In the years before the global crisis, the conduct of fiscal policy can be distinguished into two phases (Table 8). The first one, spanning the first half of the 2000s, was characterized by significant progress towards fiscal consolidation made by all of the SEE-6 countries in the context of IMF-supported adjustment programs, with a view to improving external sustainability. On the contrary, the conduct of fiscal policy displayed striking differences during 2006-08, in the very run-up to the global crisis.

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[56] The "16 percent rule" penalized banks whose loan portfolio grew faster than 16 percent annually (or 4 percent quarterly) by requiring them to buy central bank bills (bearing only 0.5 percent) by an amount equal to 200 percent of the excess growth of loans; and the "35 percent rule" required banks to hold (on a daily basis) a minimum ratio of 35 percent between liquid foreign exchange assets and liabilities.

[57] An obligation to purchase CNB bills for banks whose loan growth rate exceeded 12 percent.

Table 8

	2005	2006	2007	2008	2009	2010
General Government Balance[1] (percent of GDP)						
Albania	-3.7	-3.2	-3.9	-5.6	-7.4	-3.7
Bosnia-Herzegovina	0.8	2.2	-0.1	-3.6	-5.5	-4.3
Croatia	-2.8	-2.6	-2.1	-1.3	-4.1	-5.0
FYR Macedonia	0.2	-0.5	0.6	-0.9	-2.7	-2.5
Montenegro	-1.4	2.1	6.7	-0.3	-5.3	-3.9
Serbia	0.8	-1.6	-1.9	-2.7	-4.5	-4.6
General Government Gross Debt (percent of GDP)						
Albania	57.8	56.0	53.9	55.1	59.8	58.2
Bosnia-Herzegovina	25.6	22.0	29.8	30.8	35.9	39.7
Croatia	38.4	35.8	32.8	29.0	34.5	40.6
FYR Macedonia	39.5	32.0	24.0	20.6	23.8	24.6
Montenegro	40.9	34.8	27.5	31.9	40.7	44.1
Serbia	56.3	43.0	35.6	34.2	38.2	44.9

Source: authors' calculation on IMF's *World Economic Outlook database* (September 2011), IMF Country Reports, and REO Europe (October 2011). [1] Some minor differences may exist with the aggregate "general government net lending/borrowing".

1. Progresses on Fiscal Consolidation

In the first half of the 2000s, in Albania fiscal policy was broadly neutral (or restrictive between 2004 and 2005 – IMF, 2005b; IMF, 2006f), and a sizable reduction of public debt (from 68 percent of GDP in 2001 to 58 percent in 2005) was achieved on the back of improved tax revenue collection and spending discipline (Jonas, 2010). However, public debt remained high, even in comparison with regional peers, and its short-term maturity exposed the country to sudden changes in market sentiment and rollover risks (IMF 2006a, p. 14).

To further strengthen government solvency, an IMF-supported program approved in January 2006 was centered on two fiscal objectives: achieving a gradual reduction of public debt and net domestic borrowing as well as improvements in the current and primary balances[58]; and advancing structural fiscal reforms in the area of tax administration and public debt management.

Given that the prudential measures adopted early in the year had proved to be insufficient, in July 2006 a supplementary budget was approved for fiscal policy to complement the monetary tightening in curbing excessive credit growth and in mitigating demand pressures

[58] The program's fiscal anchor was a combined limit on net domestic borrowing and the stock of non-concessional debt. In particular, net domestic borrowing, the key fiscal target in the program, was to be reduced to 2.3 percent of GDP in 2009, from 2.8 percent in 2005. The current balance (revenue excluding grants minus current expenditure) was to be improved from 0.4 percent of GDP in 2005 to 1.9 percent in 2009. The program initially aimed to gradually reduce public debt to below 50 percent by 2009, and the authorities also committed to using half of the receipts from large privatizations to this end. Subsequently, in 2008 the authorities targeted a reduction of the debt-to-GDP ratio to below 50 percent by 2011. A significant lengthening of the average maturity of domestic public debt was another crucial measure to reduce fiscal risk (IMF, 2006a).

on the current account deficit. As a result, the 2006 budget deficit decreased to 3.3 percent of GDP, from 3.5 percent in 2005.

In Croatia, fiscal and quasi-fiscal adjustments were the instruments of choice for addressing external imbalances and closing the savings-investment gap for two reasons: first, the fiscal deficit was a major cause of aggregate demand pressures, and public debt was on an unsustainable path; and second, Croatia's focus on exchange rate stability as the guiding principle of monetary policy meant that the burden for managing aggregate demand fell on fiscal policy (IMF, 2004). With the explicit objectives of lowering the current account deficit and stabilizing the external debt-to-GDP ratio, a fiscal consolidation process, had started in 2004, in the context of the 2004-06 IMF-supported program; anchoredinto a medium-term framework since 2005 (IMF, 2005g), the process led to a significant reduction in the cyclically-adjusted fiscal balance (IMF, 2010g, p. 6).

In Serbia, the government recorded a fiscal surplus in 2005, following fiscal consolidation of over 5 percentage points of GDP between 2002 and 2005 that was carried out under the Fund-supported Extended Arrangement (EA). It is noticeable that this consolidation marked a shift in the focus of fiscal policy towards the containment of external imbalances, in the face of widening current account deficits (IMF, 2011g).

In FYR Macedonia, a successful fiscal adjustment in the context of the 2003-04 Fund-supported program had led to a budget surplus in 2004, and set the public debt ratio on a declining path, but some underlying pressures remained on both the revenue and expenditure side. Preserving fiscal discipline was critical also to ensure an orderly transition from (declining) official inflows to market financing, given that the government's still small capacity to borrow from the market constrained the financing of a large budget deficit, while, at the same time, allowing a buildup of international reserves to support the exchange rate peg.

Securing medium-term fiscal sustainability thus featured prominently in the context of the August 2005 SBA arrangement, and fiscal policy, together with monetary policy, was geared toward supporting an ambitious program of structural reforms (IMF, 2005f). The authorities anchored the tight fiscal stance to a medium-term target for the consolidated central government deficit of 0.6 percent of GDP from 2006 onward. The key to reaching this target was a broad-based containment of expenditure (including the government wage bill). Importantly, the authorities passed a supplementary budget with a deficit target for 2005 (0.4 percent of GDP after correcting for central bank recapitalization) that represented a significant tightening relative to the original target for the year (1.2 percent of GDP), and was explicitly adopted against a larger-than-expected current account deficit in 2004. As a result of such efforts, the 2005 fiscal balance outturn was in positive territory and the government was able to tap the financial markets for the first time ever with a €150 million Eurobond (IMF, 2006e).

In Bosnia-Herzegovina, fiscal policy had been prudent through 2006, as the fiscal position of the general government had been close to balance or in surplus since 2004. The adoption (starting in 2005) of statutory borrowing limits for all levels of government was a major step towards fiscal discipline. The introduction of the VAT in January 2006 generated a revenue surge, and the general government thus recorded a fiscal surplus of over 2 percent of GDP that year. At around 30 percent of GDP at end-2007, public debt was low and mostly of a

concessional nature; the general government could also rely on deposits amounting to 15 percent of GDP (IMF, 2008i). However, there were uncertainties about the size and settlement terms of some government liabilities, which were expected to raise the debt-to-GDP level by 25 percentage points in three years (IMF, 2006i).

In Montenegro, buoyant tax revenues on the back of a booming domestic demand helped generate a substantial improvement in headline fiscal balances after independence. The overall fiscal balance improved from a deficit of more than 1 percent in 2005 to a surplus of over 6.5 percent in 2007, led by strong VAT revenues from booming consumption and imports (IMF, 2009d).

2. Fiscal Policy in the Run-Up to the Global Crisis

Serbia (in 2006), Bosnia-Herzegovina and FYR Macedonia (both in 2007), and Montenegro (in 2008) all shifted to expansionary (and procyclical) fiscal policies that reversed the previous improvements in public finances

It is noticeable that this shift reversed the significant progresses towards fiscal consolidation made by these countries in the first half of 2000s under several Fund-supported programs; expansionary fiscal policies thus inevitably aggravated external and financial vulnerabilities, as they took place in the face of widening current account deficits and rising external debt ratios, often at a time when external financing conditions were also deteriorating.

These developments had prompted the Fund to forcefully underscore, in its surveillance, the case for fiscal policy to adopt a countercyclical stance, build up buffers, and contain external and financial risks (Box 2). Contrary to the previous cases, fiscal policy continued to be more cautious and attentive to external stability in Albania and, to a lesser extent, Croatia.

Box 2 - The IMF Advice on Fiscal Policy in the Run-Up to the Crisis

A recurrent theme of the Article IV Consultations that took place before the crisis was the Fund's advice to the SEE-6 countries against adopting procyclical fiscal policies, while instead repeatedly recommending a more prudent stance anchored to external sustainability. The emphasis on the need for fiscal consolidation was particularly strong for those SEE-6 countries with fixed exchange rate regimes.

For example, during the Article IV Consultation with Croatia in 2008, the Fund recommended to further reduce the 2008 fiscal deficit in order to build in some insurance against downside risks requiring fiscal action. While recognizing that the path to a deficit target of 0.5 percent of GDP by 2010 represented a considerable tightening compared with previous plans, the Fund was however in favor of a more frontloaded (and expenditure-based) adjustment in the general government budget deficit, suggesting for 2009 a target of 1 percent (or less) of GDP (against the authorities' target of 1.4 percent), and a balanced budget by 2011 (IMF, 2008f, p. 13). For the medium-term, the Fund proposed a cyclically-adjusted balanced budget as an appropriate fiscal target for creating adequate space for countercyclical maneuvers (as needed by the *de facto* pegged exchange rate regime), while placing public debt on a downward path.

In the case of Albania, as the Fund-supported program was about to end, in mid-2008 there was agreement that the fiscal anchor then in place (a combined limit on net domestic borrowing and the stock of nonconcessional debt) needed to be updated in order to continue progress on fiscal consolidation and support the authorities' plan to rely more on market financing. The objective of reducing the public debt to below 50 percent of GDP by 2011 provided the new anchor for fiscal policy. There was also agreement that a new clear and credible fiscal rule, to be chosen between an expenditure- and a deficit-based rule, would provide the best tool to pursue the debt target, while further reinforcing fiscal discipline (IMF, 2008h p. 25).

In the case of Serbia, in 2006 the Fund warned about the announced fiscal expansion explicitly on the basis of the external risks facing the country, which left little room for fiscal maneuver: in particular, external debt was rising and the current account deficit was deteriorating rapidly (it was projected to reach 14 percent of GDP in 2006 as opposed to the 11 percent targeted by the 2002-05 Extended Arrangement - EA). Against this background, the Fund recommended to adhere to the target of a fiscal surplus of 2.5 percent of GDP, as originally agreed in the context of the EA (IMF, 2006b, p. 23).

In FYR Macedonia, at end-2008 growing macroeconomic vulnerabilities led the Fund to call for abandoning the planned increases in the fiscal deficit, and instead for using fiscal policy countercyclically, by saving the strong revenue overperformance of 2008 and not executing the discretionary spending increases in the supplementary budget (IMF, 2009b, p. 15). This would produce a central government budget surplus of around 1.5 percent of GDP in 2008 (against a government's deficit target of 1.5 percent), and would limit the current account deficit to 12 percent of GDP. Eventually, the authorities reaffirmed their plans for further fiscal expansion, arguing that past fiscal prudence and debt reduction had been at the expense of a much lower stock of public capital. In their view, a fiscal expansion could prove to be usefully countercyclical given the worsening external outlook. However, the government made it clear that it stood ready to adjust its plans, should conditions deteriorate markedly.

In Bosnia-Herzegovina, when fiscal policy turned procyclical in 2007, the Fund advocated for a balanced budget for the general government as an appropriate target over the medium term, as it would gradually bring the external deficit to levels sustainable by the currency board arrangement; it would also ensure fiscal sustainability by helping to reduce the debt-to-GDP ratio to below 30 percent, a conservative target that would provide sufficient cushion in the face of the declining degree of concessionality of government debt as well as of uncertainties regarding the size of some government liabilities. While acknowledging the risks associated with the expansionary fiscal stance, the authorities saw little scope for adjusting policies. They were aware that fiscal policy was the only macroeconomic management tool in a currency board, and reiterated their commitment to such an arrangement until euro adoption (their exit strategy). While underscoring their pledge to a responsible fiscal policy, aiming at a balance or small surplus of their individual budgets over the medium term, at the time no authority was in a position to articulate clear medium-term fiscal policy objectives for Bosnia-Herzegovina as a whole (IMF, 2007e). These difficulties in fiscal policy coordination were a by-product of the country's complex constitutional setup.

The Fund cautioned once more against a fiscal stimulus in 2008, in the face of rising external stability risks and inflationary pressures, and urged the authorities to reduce the fiscal impulse in 2008 and target a balanced budget in 2009. The authorities considered a fiscal tightening unduly restrictive. In their view, the country's low debt, abundant privatization proceeds, and foreign financing all provided the fiscal space to boost much-needed infrastructure and support growth. They also argued that a small deficit would pose little risk to fiscal sustainability (IMF, 2008i, p. 24).

In Montenegro, given the unavailability of an independent monetary policy, a countercyclical fiscal policy was the only instrument available to help alleviate the buildup of macroeconomic imbalances, as well as to make up for the absence of a lender of last resort that could deal with financial instability. In order to bolster policy credibility, the Fund underscored that fiscal policy had to be cast within a medium-term expenditure framework, which could allow automatic stabilizers to work freely while strengthening the consolidation effort. The key elements of this framework (broadly supported by the authorities) were a net debt target of 20 percent of GDP by 2013[59], a downsizing of the public sector so as to make room for further tax cuts, and higher public investments.

In the face of an expansionary shift of fiscal policy at end-2007, the Fund argued for a countercyclical stance on the ground that the booming demand was masking a worsening of the underlying fiscal balances. Risks to fiscal stability were exacerbated by the large deficits projected for 2009 and beyond, given the announced plans to cut tax and contributions rates by 2010. Against the background of weakening revenues associated with a strong deceleration in demand projected for 2009, the Fund recommended a tighter fiscal stance and reiterated the call

[59] Given large government deposits, this net anchor replaced the medium-term gross debt target of 30 percent by 2012 envisaged during the 2007 Article IV Consultation.

to adhere to the medium-term net debt target of 20 percent of GDP. This target would necessitate a cancellation of the above cuts, while letting the automatic stabilizers operate. However, the authorities insisted that they could not remain passive in the face of a rapidly cooling economy, and noted that "*limited possibilities for financing large deficits would act as a natural check*" (IMF, 2009d, p. 19).

In Albania, between 2006 and 2007 the budget deficit increased from 3.2 percent of GDP to 3.9 percent, in line with the targets of the Fund-supported program. The 2008 budget accommodated a one-time expansion of the deficit to slightly more than 5 percent in order to finance a major public investment in a road project. The fiscal stance was expected to remain broadly unchanged from the previous year, since the project was highly import-intensive, with the main effect being an increase in capital goods imports in 2008 rather than a boost to domestic demand[60].

Towards end-2008, rollover risks increased on the back of a deterioration of the external environment, while high near-term budgetary financing requirements raised the threat of crowding out private investment. Accordingly, the Albanian authorities focused on reducing their financing needs as part of a strategy to strengthen the country's fundamentals. To this end, the 2008 budget was kept within the targeted deficit of 5.2 percent of GDP, and the fiscal stance for 2009 was tightened by targeting a budget deficit of 3.9 percent of GDP (IMF, 2009c)[61].

In Croatia, at the outset of the crisis the general government deficit was contained (1.3 percent in 2008[62]), and the public sector balance sheet was relatively robust, with a moderate debt-to-GDP ratio at 30 percent (above 40 percent if one includes state guarantees - IMF, 2009f, p.8).

This notwithstanding, it should be noted that Croatia's fiscal policy could have exploited more the boom years to create adequate space for demand management (IMF, 2010g, p.6; Rahman, 2010). In fact, in spite of a decline in the headline fiscal deficit, after taking into account off-budget and quasi-fiscal activities not included in the general government accounts, a "broader" measure[63] of the deficit was hardly changed during 2006-07 (IMF, 2008f; IMF 2009f, Table 2, p. 34). Furthermore, with growth particularly rapid in 2007, the overall fiscal stance was actually expansionary, as the cyclically-adjusted primary balance

[60] The 2008 budget was protected against heightened risks with a contingency reserve of some 1.5 percent of GDP, while the authorities stood ready to make cuts in expenditures through a mid-term budget review, should the deficit ceiling appear at risk.

[61] Aware that this lower deficit target would nevertheless require the government to raise, in very challenging market conditions, almost 2.5 percent of GDP in domestic financing (up from essentially zero in 2008), the budget was strengthened by the inclusion of contingency reserves of 1.9 percent of GDP.

[62] National account data for 1995-2008 were revised in 2009. This revision affected the figures for fiscal accounts as reported in various Article IV Reports.

[63] It includes repayments of "pensioner debt" and the balance of HBOR.

slipped from a slight surplus in 2006 (0.2 percent of GDP) to a deficit in 2008 (-1.2 percent) (IMF, 2010g, Table 1, p. 25)[64].

In the other four SEE-6 countries, the shift to expansionary fiscal policies was often justified on the basis of the expectation that the pace of capital inflows would remain sustained; crucially, it was facilitated by revenue buoyancy associated with the cyclical upswing or by one-off privatization receipts, both of which inflated the headline fiscal balances and masked the underlying trends; looming elections and "austerity fatigue" were also contributing factors in some countries.

In Serbia, at the end of the 2002-05 EA, the authorities had committed to achieving a budget surplus of 2.5 percent of GDP in 2006 (up from 1 percent in 2005), and of 0.6 percent for 2007 and beyond (IMF, 2006j). However, in 2006 (ahead of the January 2007 elections) the authorities felt that budget surpluses unduly constrained fiscal options; they favored a more gradual fiscal adjustment strategy, and regarded a balanced budget as appropriate for the country, also in light of favorable financing conditions. They also saw fiscal and structural policies then in place as sufficient in addressing external imbalances, and called on monetary policy to be more supportive of the external balance through interventions to avoid nominal exchange rate appreciation.

Thus, building on large privatization proceeds[65] and with limited incentives for fiscal discipline following the Paris and London Club debt write-downs, the authorities saw scope for increasing spending through large wage increases (20-30 percent in the public sector), labor tax cuts, and additional public investment (a five-year National Investment Plan, summing to at least 4.5 percent of 2006 GDP). Eventually, this procyclical fiscal expansion caused a deterioration of the fiscal balance between 2005 and 2007 from a surplus of close to 1 percent to a deficit of almost 2 percent (over 4 percentage points adrift of the EA target - IMF, 2008c; IMF, 2009a).

Fiscal policy remained procyclical also in 2008, and the budget deficit increased further to above 2 percent. More worrisomely, the structural fiscal deficit during 2006-08 also deteriorated[66], mainly as a reflection of the revenue-boosting effects of unsustainably high domestic demand relative to the level consistent with the external balance. On the positive side, public debt dropped sharply during 2005-08, from 56 to 34 percent of GDP (IMF, 2009a).

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[64] According to the European Commission (2008), the fiscal stance in 2008 was expansionary because the reduction of the headline deficit was mainly due to an accounting operation, namely the exclusion of the public road maintenance company (HAC) from general government statistics.

[65] They proposed to account one-off mobile phone license receipts of 1.6 percent of GDP in 2006 as revenue. The authorities emphasized that this additional fiscal activity in 2006 would not be debt-creating as it was being funded by license receipts. However, using the Fund's fiscal definitions for the general government (which place the license receipts below the line), the proposal represented a relaxation of 1.4 percentage points of GDP from 2005 (IMF, 2006k).

[66] In mid-2009, this deterioration was estimated at over 2 percentage points of GDP (from -2.3 to -4.7 percent - IMF, 2009e). In mid-2011, this estimate was revised downward to 0.6 percentage points (from -2.3 to -2.9 percent - IMF, 2011c).

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In FYR Macedonia, fiscal policy turned increasingly procyclical since a new government took office in 2006 with an economic program aimed to further raise growth, which included in 2007 the introduction of lower (12 percent) corporate and personal income flat tax rates. To finance these cuts, the new government allowed a modest increase in the fiscal deficit to 1 percent of GDP in 2007 and to 1.5 percent over the medium term, which were in line with the medium-term objectives of the IMF-supported program in place (IMF, 2007d).

In 2007, the central government's fiscal balance recorded a budget surplus of 0.6 percent of GDP, against a deficit target of 1 percent for the year. This was the outcome of strong revenue overperformance (3 percent of GDP above the program's target), fostered by improved tax administration. In light of this windfall, the government passed two supplementary budgets that increased spending by around 2 percent of GDP. On the positive side, public debt declined from 40 percent of GDP in 2005 to 24 percent in 2007.

For the 2008 budget, the central government deficit target was increased again (to 1.5 percent), consistent with program commitments to safeguarding macroeconomic stability and debt sustainability. Personal and corporate income tax rates were reduced further (from 12 to 10 percent). Public wages were announced to be increased by 10 percent in each of the next three years, although the authorities remained committed to meeting the 1.5 percent of GDP deficit target for 2008 (IMF, 2008d).

In the event, pensions and public sector wages were repeatedly increased in 2008; besides, rather than letting the automatic stabilizers work and save the revenue overperformance, a supplementary budget passed in July increased spending by 4 percent of GDP, to almost 40 percent of GDP. Equally worrisomely, while the *central* government deficit planned for 2008 was low (1.5 percent), the *overall* public sector fiscal deficit (including losses in the electricity sector) was by as much as 1-2 percent of GDP greater.

Despite the worsening current account deficit and strong growth in 2008, the new government (re-elected in June) planned a further fiscal expansion, through increased spending on public wages, pensions, agriculture, and education, as well as substantial cuts in social security contributions. The financing was thought to come from improved tax administration and a higher central government deficit of around 2 percent of GDP (IMF, 2009b). Going forward, the government also intended to raise the deficit even further (to 3 percent of GDP in 2009 and 4 percent in 2011) for additional infrastructure investment.

Compared to the near-balanced budget achieved under the 2003-04 Fund-supported program, this expansionary stance represented a "*paradigm shift*" in fiscal policy (IMF, 2009b, p. 14), which was to exacerbate the country's external vulnerabilities. In fact, the fiscal deficit planned for the fourth quarter of 2008 (4 percent of GDP) was expected to translate mostly into an increase of the current account deficit (to around 14 percent of GDP, against 6 percent envisaged by the 2005 program).

The external risks posed by the expansionary fiscal policy were even more evident in light of the expected deceleration in growth (from close to 6 percent in 2008 to 4 percent in 2009) as a result of the global financial crisis as well as of the substantial government's external financing needs (averaging 4 percent of GDP annually).

In Bosnia-Herzegovina, fiscal policy became procyclical in 2007, reflecting increased public spending in the run-up to the October 2006 election. The general government budget surplus

of over 2 percentage points of GDP in 2006 was depleted in 2007, adding a sizeable fiscal impulse (1.2 percent of GDP in cyclically-adjusted terms) to an already-strong domestic demand (IMF, 2008i).

On the positive side, a breakthrough in strengthening public finances was made in October 2008, with the long-awaited introduction of the National Fiscal Council, and the agreement on a permanent indirect revenue-allocation formula. These key structural fiscal measures aimed to help overcome the complexity of inter-governmental fiscal relations, and to improve coordination between the various governments in setting and pursuing their fiscal policy objectives. Strong revenue performance continued in 2008, but a number of factors, notably continued loose public-sector wages policy and customs revenue loss, were already putting pressure on public finances[67]. Ultimately, the general government budget deteriorated from a broadly balanced position in 2007 to a deficit of about 4 percent of GDP in 2008 (IMF, 2009g), twice as much as the value projected in mid-2008[68].

In Montenegro, notwithstanding their fiscal consolidation objectives in the medium-term, the authorities' short-term fiscal stance was predicated by nation building expenditures and prior commitments to reducing tax rates. As a result, the authorities were reluctant to just allow the fiscal stabilizers to work fully, and indeed adopted a highly expansionary budget for 2008. This procyclical stimulus, which added to an already overheating economy, included reductions in social contribution rates, large public wage increases (30 percent), and a cut in the personal income tax (to 15 percent, with a further cut to 9 percent beginning from 2010). As a result, the large headline budget surplus of 2007 (above 6.5 percent of GDP) turned into a slight deficit in 2008, and a much larger deficit of over 6 percent was also projected for 2009. More worrisomely, the structural fiscal balance deteriorated from a surplus of about 1.5 percent in 2006 to a deficit of over 3 percent of GDP in 2008, which was projected to reach 9 percent in 2009 (IMF, 2009d).

IV. Immediate Responses to the Global Crisis

The deterioration in the external environment faced by the SEE-6 countries was greatly magnified by the Lehman Brothers bankruptcy in September 2008, and began to be felt in late-2008 and early-2009[69]. Overall, such deterioration exposed and, more consequentially, exacerbated internal and (above all) external vulnerabilities (first and foremost sizable financing needs) affecting the macro-financial stability of these economies. The crisis was

[67] These pressures were different across the two Entities. In the RS, receipts from the privatizations allowed it to finance additional spending associated with sharp wage increases (the RS central government's wage bill rose by about 40 percent in 2008). In contrast, the Federation faced a fiscal crisis, triggered by large unfunded spending legislation related to benefits for war veterans and demobilized soldiers (absorbing a third of the Federation's budget), and the lack of progress with the privatization agenda. By end-2008, the Federation's budget accumulated expenditure arrears of 1.4 percent of national GDP (IMF, 2009g).

[68] The structural fiscal balance deteriorated by 4 percentage points between 2007 and 2008 (IMF, 2009g).

[69] It has aptly been noted that the economic cycle had started to turn down in many European transition countries ahead of September 2008. More precisely, internal factors such as overheating, tighter lending standards and monetary policy were stronger contributors to this reversal than external factors such as credit crunch and slowing growth in advanced economies since mid-2007 (EBRD, 2009, p. 56).

transmitted via trade and financial channels, and materialized through collapsing exports, declining capital inflows and remittances, loss of external financing, lower tax revenue, tightened domestic credit conditions, and pressures on exchange rates.

As a result, GDP growth slowed down abruptly, and in 2009 turned negative in all countries but Albania, where it remained positive (at over 3 percent). Croatia and Montenegro suffered the most severe recessions, with GDP plunging by about 6 percent, while the downturn was modest in FYR Macedonia, where output declined by less than 1 percent. In Bosnia-Herzegovina and Serbia, the two countries that requested financial assistance from the IMF, the decline in GDP falls in between the previous extremes, in the range 3-3.5 percent. The depth of the recession in the SEE-6 countries seems to be broadly in line with the general pattern of European transition countries, whereby output losses during the crisis appear to be proportional to such pre-crisis vulnerabilities as the size of the credit boom and (above all) the level of external debt (EBRD, 2009, p. 58).

The global instability brought about higher risks and volatility in these countries' financial sectors, as they found themselves vulnerable to worsening cross-border funding conditions and deteriorating credit quality. Most countries experienced a major threat to financial stability in the form of deposit withdrawals ("mini bank runs"), in some cases triggered by concerns about the financial health of foreign parent banks of domestic subsidiaries (NBS, 2009; IMF, 2009f). In Montenegro households' deposits began to grow again only in 2011.

However, the overall soundness of their banking systems was a key common strength of the SEE-6 countries, and the authorities' prompt responses contributed to preserving financial stability. The key measure to support the public's confidence in the banking systems was the increase in the coverage of the deposit insurance schemes[70]. Moreover, liquidity support to domestic subsidiaries on the part of foreign parent banks proved to be crucial in stabilizing financial condition, including in the foreign exchange markets[71]. As a result, for European transition countries as a whole, the "sudden stop" in net capital flows (including bank lending) suffered in the fourth quarter of 2008 and the first quarter of 2009 was moderate on average when compared to other regions (EBRD, 2009, p. 54).

Against this common background, the SEE-6 countries entered the crisis with varying degrees of policy space, which were reflected in their different abilities to mitigate the effects of the turmoil. In general, the countercyclical policy responses had to find a balance between supporting growth and containing external imbalances and financing needs. These responses were shaped to a great extent by the type of exchange rate regime in place.

In fact, in Bosnia-Herzegovina, Croatia, and FYR Macedonia a standard countercyclical response was made difficult by the fact that monetary and fiscal policies had to be mainly geared towards the preservation of the fixed (or quasi-fixed) exchange rate regime. In Montenegro, the fiscal relaxation adopted at end-2008 to contain the crisis had to be hastily

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[70] It has been pointed out that, at least initially, there was "*skepticism and even cynicism*" about the credibility of such a deposit insurance, as no government was thought to be able to fully recompense depositors in the event of a serious bank run and subsequent collapse of major banks. Sanfey (2010, p. 11).

[71] "*Parent banks also provided a strong boost to banks' foreign currency liquidity by promptly providing credit lines to their Croatian subsidiaries*" (CNB, 2009, p. 8). See also CBM, 2009, p. 2, and NBS, 2009, p. 42.

reversed in early-2009 because of collapsing revenues. In the face of greatly reduced access to external financing, curbing the expansionary fiscal stance was also necessary in Serbia to contain the current account deficit. This country, along with Albania, could rely on a depreciation of the national currency as a shock absorber, while the flexible exchange rate also allowed for some monetary easing.

Setting aside the scope for countercyclical economic policies, the impact of the crisis generally depended on the size of the shocks and the countries' initial vulnerabilities.

A distinguished factor to account for the most severe deceleration in GDP growth suffered by Montenegro (from 7 percent in 2008 to -6 percent in 2009) was the overextension of the banks' balance sheets, which amplified the impact of the international financial turmoil. Ultimately, broad-based deposit withdrawals and rising NPLs led to a credit crunch that overtook the fiscal contraction as a cause of the recession (IMF, 2010f).

In Albania, the authorities were able to use a mix of economic policies to mitigate the impact of the crisis, building on an overall prudent fiscal stance, a flexible monetary policy framework, and substantial foreign exchange reserves. In fact, despite having larger deficit

2007 Albania stands out as the only country

necessary macroeconomic adjustment[72]. The inability to use fiscal policy to mitigate the impact of the crisis was a factor that contributed to these decisions.

Serbia faced the sudden deterioration in the external environment from a vulnerable position, as a result of a "*strong dissonance*" (IMF, 2009a): growth and inflation outcomes were broadly consistent with internal balance, but they were accompanied by the buildup of an increasingly unbalanced external position, with the current account deficit standing at more than 20 percent of GDP in 2008, one of the highest in Eastern Europe.

Although the country enjoyed some first lines of defense (for example, Serbian banks had large liquidity and capital buffers), the authorities requested a Stand-by Arrangement (SBA) with a short duration (15 months) and relatively high (but not exceptional) access (75 percent of quota, about US$540 million); they initially intended to treat the arrangement as precautionary[73], distinguishing Serbia from the "emergency SBAs" approved for other Eastern European countries (IMF, 2011g). In fact, a key feature of the Fund's role was to serve as an internal commitment device. The program was approved by the IMF Board in January 2009.

This notwithstanding, risks to external stability remained high chiefly as a result of large gross external financing requirements (25-30 percent of GDP), stemming from the current account deficit and rising external debt amortization after years of heavy borrowing. Uncertainty on the size of FDI inflows posed another key risk, as the IMF-supported program assumed continuation of these inflows as well as of corporate access to external funds. As a consequence, a sharp contraction in available external financing could make the lingering risks become visible, and could precipitate a financial crisis.

This scenario did materialize abruptly in the last quarter of 2008, triggered by the Lehman Brothers bankruptcy. The ensuing downturn proved to be much deeper and more protracted than earlier projected , with an envisaged contraction in GDP by 2 percent in 2009 (against a previous expectation of positive growth of 3.5 percent) and a U-shaped recovery pattern involving no growth in 2010 (IMF, 2009e).

On the one hand, the deeper-than-expected downturn implied a faster adjustment of the current account deficit and, correspondingly, lower financing requirements. ON the other hand, however, external financing fell significantly short of earlier assumptions, and debt amortization turned out to be higher due to the accumulation of short-term liabilities at end-2008. Accordingly, the country was projected to face a sizable cumulative external financing gap during 2009-11 of about 11.5 percent of GDP (€3.5 billion - IMF, 2009e, Table 5).

Against this background, on the occasion of the first review of the SBA (May 2009), the Fund approved the authorities' request for an extension and augmentation of the program (to US$3.9 billion or 560 percent of quota). The adjustment framework was revised with a view of facilitating an orderly rebalancing of the economy, and was centered on the awareness that

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[72] Along with Macedonia FYR, Bosnia-Herzegovina and Serbia used up the 2009 General and Special SDR allocations to help fund their external and fiscal financing requirements.

[73] It was understood that, should adverse spillovers to Serbia prove significantly graver than projected, the SBA could serve as a "launch pad" for a higher-access arrangement.

both private and public sectors needed to reduce their absorption levels in line with sustainable incomes and available external financing. In this regard, a key assumption of the program was a permanent reduction of capital inflows from their pre-September 2008 levels.

In Bosnia-Herzegovina, the impact of the global crisis is epitomized by the fact that the economy moved from overheating in mid-2008 to a contraction of GDP of around 3 percent in 2009, with headline inflation (year-over-year) declining from a peak of 10 percent in July 2008 to a negative value of close to 2 percent in mid-2009.

While the authorities managed to address an outflow of bank deposits and restrained government spending to counter a revenue shortfall, they recognized that there were limits to this effort due to the severity of the downturn (IMF, 2009g). This impacted the country primarily through a further significant deterioration in the fiscal position (CBBH, 2009, p. 19)[74]. As a consequence, the high structural fiscal deficit, large external financing needs, and the loss of reserves by the central bank (16 percent between September 2008 and May 2009) all threatened the stability of the currency board. At the same time, the sharp deterioration in the structural fiscal balance and tight financing constraints did not leave room for countercyclical fiscal policy. In fact, under unchanged policies, the headline deficit was set to widen to about 8 percent of GDP, implying an additional deterioration in the structural balance of 1.5 percentage points. Absent a policy correction, the deficit looked set to spiral over the medium term (IMF, 2009g).

To safeguard the currency board[75], in July 2009 the authorities obtained a 36-month SBA equal to 600 percent of the quota (US$1.5 billion) to support an adjustment program aimed at redressing fiscal imbalances and strengthening the financial sector. Fund resources were to be used mostly to replenish the reserves of the central bank and to help fill the fiscal financing gap, so as to avoid crowding out of domestic lending to the private sector.

As far as the financing role of the Fund is concerned, it is noticeable (Table 9) that Serbia's external financing needs projected at the time of its request for Fund assistance (29 and 26 percent in 2009 and 2010, respectively - IMF, 2009e, Table 5, p.31) were at least as high as Croatia's (37 and 30 percent of GDP - IMF, 2009f, Table 6, p.38). Moreover, this country's projected external financing needs were much higher than those of Bosnia-Herzegovina (11 percent of GDP annually over 2009-2011, mostly owed to the financing of the government budget deficit - IMF, 2009g, Table 10, p.37).

The above evidence is a *prima facie* suggestion that the size of a country's projected external financing requirements, if thought of as a proxy of the probability that it faces an external financing gap, is necessarily an insufficient predictor of the likelihood of a request for Fund financing. In fact, even in unsettled financial market conditions, a country's ability to maintain access to market financing (domestic or external) is key for the sustainability of

[74] As noted in Section III.C.2, the latter had already widened to 4 percent of GDP in 2008 (against a target of about 2 percent), from a near balance in 2007.

[75] The currency board was probably among the strongest institutions in the country, had been immune to political interference, enjoyed political support, and remained a key macroeconomic policy anchor. Moreover, the lack of strong evidence of a significant real exchange rate misalignment, and sizeable liquidity buffers built by the central banks and commercial banks reinforced the case for retaining the currency board (IMF, 2009g).

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external (and fiscal) financing requirements. This ability may come to depend on several factors, notably the size (and trend) of the government's budget deficit; more generally, it depends on the confidence of financial markets on the sustainability of public finances and the soundness of macroeconomic fundamentals.

Table 9

Croatia and Serbia - Projected External Financing Requirements and Source (billions of euros)

	2009			2010		
	Serbia		Croatia	Serbia		Croatia
	SBA Request	1st Review		SBA Request	1st Review	
Gross Financing Requirements	**8.9**	**9.0**	**16.6**	**11.0**	**7.9**	**13.6**
in percent of GDP		*29.1*	*37.0*		*25.8*	*30.1*
Current Account Deficit	5.8	4.0	2.9	6.0	3.1	1.8
in percent of GDP		*13.0*	*6.5*		*10.1*	*4.1*
Debt Amortization	4.1	5.0	13.6	4.3	4.3	11.7
in percent of GDP		*16.1*	*30.5*		*14.0*	*26.0*
- Medium and long-term debt	2.9	3.0	8.3	3.2	2.8	6.5
- Short-term debt	1.2	2.0	5.3	1.2	1.5	5.2
Available Financing	**8.9**	**6.6**	**16.6**	**11.0**	**6.7**	**13.6**
FDI (net)	1.9	1.0	1.8	2.3	1.2	1.9
in percent of GDP		*3.2*	*4.0*		*4.0*	*4.3*
Debt Financing	6.0	4.4	12.6	7.3	5.7	12.0
in percent of GDP		*14.4*	*28.1*		*18.7*	*26.5*
- Medium and long-term debt	4.9	2.9	7.3	6.1	4.2	6.7
- Short-term debt	1.2	1.5	5.3	1.2	1.5	5.2
Gross international reserves	-	0.6	1.6	-	-	0.6
in percent of GDP		*2.0*	*3.6*			*1.4*
Financing Gap	**0.0**	**2.4**	**0.0**	**0.0**	**1.1**	**0.0**
in percent of GDP	-	*7.7*	-	-	*3.7*	-

Source: IMF, 2009a, 2009e, and 2009f.

In this regard, one has to underscore, *inter alia*, that in 2008 Croatia's budget deficit was smaller than Serbia's and was on a declining path as a result of a more prudent fiscal policy. On the contrary, when Bosnia-Herzegovina approached the Fund, the budget deficit was set to double to about 8 percent of GDP in 2009 in the absence of corrective measures, and the capability of financing the fiscal gap through domestic or external sources was severely constrained.

B. Fiscal Policy

When the crisis hit, the SEE-6 countries had generally limited or no room for adopting countercyclical fiscal policies, much less through the use of discretionary measures[76]. In order to contain heightened external imbalances and to counter a crisis-induced collapse of revenue, most of these countries had to rein in the expansionary fiscal stance adopted in the years immediately prior to the crisis, a stance that had itself undermined external sustainability. As a result, the immediate fiscal response had generally to be limited, at best, to the operation of automatic stabilizers.

Between 2008 and 2009, headline fiscal balances deteriorated in all SEE-6 countries, as growth rates turned out to be significantly lower than initially expected and in negative territories, with the exception of Albania (Table 10).

Table 10

General Government Balance - Projections and Outturns*

	2008				2009			
	GDP growth (percent)		fiscal balance (percent of GDP)		GDP growth (percent)		fiscal balance (percent of GDP)	
	projection	outturn	projection	outturn	projection	outturn	projection	outturn
Albania	6.1	7.5	-5.2	-5.6	6.3	3.3	-3.0	-7.4
Bosnia-Herzegovina	5.5	5.7	-1.9	-3.6	5.0	-2.9	-2.5	-5.5
Croatia	4.0	2.2	-2.4	-1.3	3.5	-6.0	-1.5	-4.1
FYR Macedonia	5.5	5.0	-1.5	-0.9	4.0	-0.9	-3.0	-2.7
Montenegro	7.2	6.9	2.3	-0.3	5.5	-5.7	1.3	-5.3
Serbia	6.0	3.8	-1.8	-2.7	5.5	-3.5	-1.5	-4.5

*Projected data are from 2008 Country Reports.

Moreover, between 2009 and 2010 a procyclical fiscal tightening in structural terms was undertaken in most SEE-6 countries in order to address medium-term fiscal sustainability (Table 11).

In particular, a sizable fiscal adjustment was the centerpiece of the Fund-supported programs for Serbia and Bosnia-Herzegovina (Box 3). In both cases, the adjustment included significant wage restraints (on top of cuts in other recurrent spending) to counter the increases approved right before the crisis. It is also noticeable that the size of the fiscal adjustment had to be somewhat relaxed over the course of the programs, as the extent of the downturn turned out to be worse than initially expected, and automatic stabilizers were ultimately allowed to play (almost in full) in order not to aggravate it.

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[76] Even if fiscal space were available, the financing of deficit-spending policies could have been severely constrained by unfavorable market conditions (Sanfey, 2010). The same author notes that, although fiscal deficits in most countries were generally fairly contained when the crisis hit, "*it is now obvious in retrospect that they should have been more conservative*".

Table 11

Structural Fiscal Balances (percent of GDP)

	2008	2009	2010
Albania	n.a.	n.a.	n.a.
Bosnia-Herzegovina	-4.2	-4.8	-3.9
Croatia	-2.3	-2.9	-3.2
FYR Macedonia	-3.9	-3.1	-2.0
Montenegro	-5.8	-7.2	-5.6
Serbia	-2.9	-3.2	-2.9

Source: Country Reports and IMF's *World Economic Outlook Database* (September 2011).

As already noted, Albania was the only country where the authorities were able to provide a significant (and partly discretionary) fiscal stimulus. In the first place, automatic stabilizers on the revenue side were given full play, and an additional fiscal boost was provided through cuts in social security contributions and strong expansionary measures prior to the mid-2009 elections. Eventually, the fiscal deficit increased to above 7 percent of GDP in 2009. This fiscal accommodation is notable as it overturned the policy tightening planned for the year, with a budget deficit target of about 4 percent of GDP (down from slightly more than 5 percent in 2008) established in November 2008.

Contrary to Albania, in Croatia, FYR Macedonia, and Montenegro the conduct of fiscal policy in the aftermath of the crisis was significantly constrained by the recession-induced collapse of tax revenue, which made budget financing increasingly difficult.

In FYR Macedonia, the authorities adopted a fiscal stance aimed at supporting growth and preserving public investment. To this end, they targeted a government budget deficit for 2009 and 2010 (2.8 percent and 2.5 of GDP, respectively) that mainly reflected the operation of automatic stabilizers. While higher than the 2008 outturn (about 1 percent of GDP), in cyclically-adjusted terms these deficits amounted to a moderate contraction in both years, which was appropriate in light of rising financing constraints and the need to contain the current account deficit (IMF, 2010a). In order to secure budget financing for 2009 and bolster reserves, the government also issued a €175 million Eurobond in July.

In Montenegro, the severe contraction of the economy and the loss of import-related revenue dramatically exposed the structural nature of the deterioration in the fiscal position occurred during the boom years, which undermined the ability of raising financing (IMF, 2010f, p. 11). According to Fund estimates, the structural fiscal deficit stood at about 8 percent of GDP in 2008 and 2009, and slightly lower in 2010, reflecting discretionary tax cuts and expenditure increases before the crisis.

Against this challenging background, the authorities proved to be able to undertake a swift fiscal adjustment in 2009, by quickly reversing the stimulus package adopted in the fall of 2008. Specifically, with a view to containing budget financing requirements, the authorities adopted a mid-year revision of the state budget, while similar adjustments at the local level resulted in a decline in expenditure (including through wage cuts) by 4.5 of GDP. This correction could not prevent a deterioration of the (overall) general government deficit by

around 5 percentage points, between 2008 and 2009 (IMF, 2010f). Public debt rose by almost 10 percentage points, to close to 40 percent of GDP, while the blanket guarantee to bank deposit introduced in October 2008 posed a large fiscal contingent liability (close to 50 percent of GDP).

At the onset of the crisis, the Croatian authorities managed to cut spending in order to offset a revenue shortfall that had started in late-2008 and had deteriorated in the first quarter of 2009. In late-December 2008, a general government deficit of below 1 percent of GDP was targeted for 2009, but the worsening economic outlook made this target increasingly untenable. In April, a revised budget provided a more realistic framework, and targeted a deficit of 1.6 percent of GDP, which included additional spending cuts. This new target implied a cyclical tightening of 1 percent of GDP, which was necessary in view of Croatia's vulnerable external position, tight domestic financing conditions, and the need to preserve space for crisis-related contingencies (IMF, 2009f). Downside risks materialized in the course of 2009 and GDP fell by close to 6 percent. As revenue underperformance continued, budgetary pressures and costlier access to foreign financing forced the government to step up its domestic borrowing, increasingly in foreign currency.

The case of Croatia is notable in that tight external financing conditions impacted domestic credit conditions through the pressures exerted on the funding of the government budget deficit[77]. In fact, while in late-2008 the budget financing gap was filled by issuing treasury bills, in the first half of 2009 the government turned increasingly (and significantly) to banks. As a result, total borrowing of the central government from domestic banks increased by about 50 percent in the first five months of 2009[78].

All in all, to offset plunging revenues and contain the 2009 budget deficit to financeable levels, the authorities adopted three supplementary budgets with a number of short-term measures that included expenditure cuts, a wage and pension freeze, a VAT rate hike, and the introduction of a "solidarity tax" on high incomes. This notwithstanding, in 2009 the general government's overall fiscal deficit eventually widened to 4 percent[79] of GDP (against an original target of close to 1 percent), and the deficit of the broader public sector grew to over 5 percent of GDP. Public debt also rose sharply to 50 percent of GDP (including guaranteed debt), from 43 percent in 2008.

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[77] See Mihaljek (2009) for a review of Croatia's fiscal policy in 2009.

[78] According to Mihaljek (2009, p. 244), this shift towards bank financing led to a severe crowding out of the private sector, as lending to households declined steady, while lending to non-financial corporation increased by less than the corresponding period from the year before. In turn, this crowding out allegedly forced the private sector to withdraw bank deposits in order to finance its maturing obligations (between end-2008 and May 2009, demand deposits declined by almost 20 percent). At end-2008, the increased access by domestic corporates to their bank deposits to finance their liquidity needs is interpreted as a sign of reduced supply of credit also by the NBS (2009, p. 32). However, according to Jankov (2009, p. 132), the stagnation of the credit to the private sector was due to demand rather than supply factors. In the same vein, Galac (2010) finds no statistical evidence that the surge in government borrowing from domestic banks has directly led to slower credit growth than warranted by other fundamentals.

[79] Including the payment for a called guarantee of a public shipyard.

Box 3 - Fiscal Policy in the Context of the IMF-Supported Programs for Serbia and Bosnia-Herzegovina

1. Serbia

The authorities first committed to containing the 2008 general government deficit to 2.3 percent, against an adopted budget that was consistent with a deficit of 2.7 percent of GDP. Further fiscal consolidation was to take place in 2009 and 2010, with the general government deficit slated to decline to 1.8 and 1.0 percent of GDP, respectively. Carryover effects and pre-commitments in terms of extraordinary pension increases limited the room for fiscal maneuver (IMF, 2011g). The medium-term fiscal framework was anchored through a structural deficit target of about 1 percent of GDP from 2011 onwards (IMF, 2009a), which would bring the debt-to-GDP ratio to close to 20 percent by 2013.

As a result of a deeper recession (projected GDP growth for 2009 was revised downward from a positive value of 3.5 percent at the time of the initial approval of the program to minus 2 percent), fiscal outturns turned out to be weaker than expected, as tax collection underperformed by over 1.5 percent of GDP. The actual 2008 fiscal deficit stood at 2.7 percent of GDP (IMF, 2011k), higher than the 2.3 percent target.

The extended and augmented program approved by the Fund in March 2009 included a revised strategy based on three mutually reinforcing pillars: 1) additional fiscal adjustment; 2) private sector involvement as part of an innovative Financial Sector Support Program (FSSP); and 3) additional external financing from IFIs. This strategy would also provide a framework for launching long-delayed structural reforms to strengthen the economy's still weak supply side. A key assumption was a permanent reduction of capital inflows from their pre-September 2008 levels.

The additional fiscal tightening was once again a cornerstone of the revised program; the tighter stance was necessary as, under unchanged policies, the fiscal deficit was projected to rise to 6.3 percent of GDP in 2009 (against a previous target of 1.8 percent), and would continue to spiral upward over the medium term. This trend reflected two key drivers: 1) a revenue-to-GDP ratio normalizing towards a significantly lower level, as the economy rebalanced away from pre-crisis excess domestic demand; and 2) crucial budgeted expenditure items (notably public wages and social spending) exhibiting strong nominal inertia in the short-term, despite a nominal freeze.

Despite the tighter stance, the new program allowed an upward revision of the targets for the fiscal deficit in both 2009 and 2010 (to 3 percent and 2.5 of GDP, respectively), given a worse-than-projected macroeconomic environment and concerns for social implications. The expenditure-based adjustment relied mainly on *ad hoc* nominal freezes of public wages and pensions through 2010, as well as on deep cuts in discretionary spending (including capital), while protecting social spending. Moreover, to sustain fiscal consolidation, the adjustment strategy was anchored to a medium-term structural deficit target of 1 percent of GDP from 2012 onwards (IMF, 2009e, Table 12, p. 40).

The gradual achievement of this objective was based on large, but back-loaded, reductions in current spending, which would have to be complemented by a package of structural fiscal reforms needed to counteract strong procyclical deficit and spending biases. Significant tax increases (notably a higher VAT rate) were avoided. The government's adjustment strategy appeared ambitious, but also came with implementation risks, as it would require an unusually strong and steadfast effort within a potentially difficult political setting. With these risks in mind, the Fund advocated instead for an adjustment mix consisting of a front-loaded VAT increase combined with back-loaded current spending reforms (IMF, 2010b, p. 8).

On the occasion of the second review of the SBA in December 2009, the fiscal targets for 2009 and 2010 were revised upward for a second time, to 4.5 and 4 percent of GDP respectively. This change meant to allow automatic stabilizers to play almost in full, in the face of an even deeper output contraction in 2009 than earlier projected (-3.0 percent in December versus -2.0 percent in May) and, above all, a deeper decline in domestic demand (-8.0 versus -5.6 percent). The worse downturn also led to a revision of the medium-term deficit target, now set at 1 percent of GDP by 2015 for the *overall* fiscal balance (IMF, 2010b, Table 9, p. 28), as opposed to a previous target of 1 percent of GDP by 2012 for the *structural* balance.

2. Bosnia-Herzegovina

The program envisaged a gradual fiscal adjustment, with fiscal deficits targeted at 4.7 percent of GDP in 2009 and 4.0 percent in 2010. Given the key objectives of safeguarding the currency board and restoring fiscal sustainability, this strategy initially did not allow automatic stabilizers to work in full (IMF, 2009g, p. 16).

The adjustment path focused on cuts to recurrent expenditure in the short-term so as to somewhat reverse sharp pre-crisis increases and re-establish public wage policy restraint. These measures were supported by structural fiscal reforms, most importantly of the systems of pensions and right-based benefits, the budget process, and public finance management. The goal was to reduce the debt-to-GDP ratio to below 30 percent over the medium term (IMF, 2010d).

As a consequence of a marked revenue shortfall, the actual 2009 general government deficit exceeded the program target by one percentage point (5.7 percent versus 4.7 percent – IMF, 2010l), despite the authorities' efforts to keep expenditure under control.

Further measures were adopted as, under unchanged policies, the fiscal deficit was trending to reach 6 percent in 2010. As a result, in March 2010, on the occasion of the first review of the program, the target for the general government deficit in 2010 was revised upward (to 4.5 percent from the original 4 percent) in order to take into account the still-weak revenue performance and strong expenditure pressures ahead of the October 2010 elections.

The new target aimed at striking a balance between a countercyclical fiscal policy to contain the downturn and medium-term consolidation objectives. Having accommodated larger deficits in 2009-10 was supposed to result in only a slightly wider fiscal financing gap, and the additional financing needs were to be met through bank financing.

C. Monetary and Exchange Rate Policies

As mentioned before, the ability of four SEE-6 countries to use monetary policy (particularly the interest rate) in a countercyclical fashion was severely constrained (or flatly non-existent) by the exchange rate regime. On the contrary, in Albania and Serbia the monetary and exchange rate frameworks in place worked as a shock absorber in the unstable conditions of the post-Lehman Brothers bankruptcy, as both countries were able to ease monetary policy (with different degree of effectiveness) and benefited from a large nominal depreciation of their currencies.

In Serbia, the IMF-supported program of January 2009[80] introduced a key innovation for the conduct of monetary policy. The NBS's focus on the inflation target as the economy's nominal anchor was strengthened by replacing *core* inflation with *headline* CPI inflation as the target. This indicator, involving a broader range of goods and services, was seen as a stronger anchor for inflation expectations and wage indexation.

In this context, the floating exchange rate proved to be a stabilizing factor against the external shocks[81], and the dinar depreciated markedly vis-à-vis the euro (about 20 percent

[80] The NBS and the government committed to signing a memorandum of understanding on inflation targeting, and a memorandum of understanding on their respective roles and responsibilities in maintaining financial stability (IMF, 2010c).

[81] "*In addition to the stable banking sector, it was the flexible exchange rate policy that stood to defend Serbia from the first wave of the crisis and, together with high foreign exchange reserves, contributed to the stabilization of the financial market in an environment of rapidly declining foreign exchange liquidity*" (NBS, 2008, p.5).

between September 2008 and May 2009). It remained stable without market interventions throughout most of 2009, but depreciation pressures re-emerged in December 2009, in part reflecting seasonal developments[82].

The implementation of conventional monetary policy easing in 2009-10 faced however a number of challenges, first and foremost because of Serbia's higher inflation rate than its peers (the highest in the region during 2004-08, on average – IMF, 2010c). While the inflation rate had been on a downward trend since mid-2008, it remained high mostly due to the high pass-through of the large currency depreciation and increased indirect taxes. Moreover, high inflation expectations proved to be well-entrenched and responded only slowly to the decline in actual inflation. These factors affected competitiveness and outweighed the mitigating effect on prices arising from slowing activity and decelerating nominal wage growth brought about by the crisis. Finally, continued financial market instability and the attendant uncertainty further impaired the already weak (because of high euroization) interest rate and credit channels of the monetary policy transmission mechanism.

As a result of these inflation dynamics, the NBS's room for maneuver was somewhat constrained and only in January 2009 it was able to start gradually easing its tight monetary stance and lowering its policy interest rate (repo rate) to support credit and economic activity. Subsequently, in April 2009 the broad stability of the exchange rate and some signs that inflation was declining to single digits allowed the NBS to further cut its policy interest rate by 250 basis points in two steps (to 14 percent). By September 2009, inflation had indeed fallen faster than projected, mainly on account of decelerating food and utility prices, while inflation expectations started to gradually moderate in early-2010 (IMF, 2010i). Eventually, the inflation targeting framework, supported by restrained nominal wage growth, a tight fiscal stance, and macro-prudential measures, allowed Serbia to achieve significant disinflation gains, with inflation falling below the NBS's target band of 6±2 percent during the first half of 2010[83].

In Albania, monetary easing complemented the fiscal stimulus and the use of liquidity buffers in the countercyclical response to the crisis. Monetary conditions were initially loosened by means of quantitative easing in late 2008 (via direct liquidity injections by the BoA); interest rate cuts by 50 basis points each followed in January and October 2009. Meanwhile the *lek* depreciated by a cumulative 14 percent (IMF, 2010h). Inflation remained mostly in line with the target of 3±1 percent, though depreciation pass-through and higher electricity prices at times lifted inflation above 4 percent. These developments prompted the BoA to adopt a relatively prudent stance when compared to many other central banks in the region, in order to keep inflation expectations well anchored.

The NBRM's response to the crisis is emblematic of the constraints posed by the commitment to a *de facto* fixed exchange rate regime. A collapse in export demand and the loss of external financing triggered a rapid loss of foreign exchange reserves, raising uncertainties about its sustainability and forcing the NBRM to intervene heavily to protect

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[82] The NBS's FX intervention strategy allowed for limited and targeted interventions in the short term to smooth shocks, preserve financial stability, and support the policy interest rate in achieving inflation objectives.

[83] Inflationary pressures resumed since the second half of 2010, prompting the NBS to reverse its easing stance and increase the policy rate (IMF, 2010j).

the currency peg. Currency substitution and cash outflows by residents added to pressures on reserves. By May 2009, central bank reserves had fallen 30 percent below the October 2008 peak, and were able to cover only 75 percent of short-term debt (IMF, 2010a).

Against this background, in the first half of 2009, the NBRM took several steps to tighten credit conditions and stop the outflow of foreign exchange reserves. First, it imposed liquidity requirements in January; second, it hiked its policy rate (one-month central bank bills) from 7 to 9 percent in April, a notable move as inflation had fallen to zero; and third, it raised reserve requirements on bank deposits in June.

The NBRM's monetary tightening stood out among the countries in the region, which generally reduced interest rates and relaxed reserve requirements. This tight stance was feasible because banks' balance sheets were sufficiently healthy to absorb the above measures. This response helped rebuild reserves both directly (commercial banks reversed the accumulation of foreign assets to meet higher reserve requirements) and indirectly, by slowing bank lending. Reserves were further bolstered by a Eurobond issue and the SDR allocation of €60 million. By end-October 2009, reserves had recovered most of their losses from the previous year, and rose to a level that fully covered short-term debt (IMF, 2010a).

At the end of November 2009, against a backdrop of contained inflation and below-potential output, the NBRM started an easing cycle that progressively led to a reduction of its reference rate from 9 percent to 4 percent in December 2010. This move was facilitated by favorable trends in the balance of payments and international reserves, while considering other factors such as price pressure, degree of slack in the economy and interest rates in the Euro Area (IMF, 2011b).

In Croatia, the authorities faced the difficult task of cushioning the impact of the crisis, while remaining committed to keeping the *kuna* broadly stable, as ; a large depreciation could trigger negative balance sheet effects that in turn would entail risks to financial stability.

While some limited exchange rate flexibility was permitted in the first half of 2009, the strategy of allowing the exchange rate regime to work as an anchor in the face of heightened uncertainty inevitably constrained the policy response. In order to contain pressures on the *kuna,* this strategy required adequate external financing as well as supporting monetary and fiscal policies, with a view to limiting the financing needs of the public sector and maintaining tight liquidity conditions in the banking system,

In practice, the CNB kept the repo auction rate broadly stable at 6 percent, while addressing emerging liquidity pressures in the banking system through active use of regulatory requirements and repo auctions; intermittent FX interventions to limit the depreciation of the *kuna* resulted in some reserve loss between September 2008 and March 2009.

The policy response succeeded in stabilizing markets and strengthening confidence. The *kuna* fully retracted its losses in mid-2009, official reserves were replenished, and Croatia successfully tapped international capital markets twice in 2009. In the course of 2010, a stable foreign exchange market and subdued inflation outlook allowed a moderate easing of monetary policy (IMF, 2010g).

D. Impact on the Banking Systems

A defining feature of the impact of the global crisis on the SEE-6 countries is the absence of a large-scale banking crisis (usually triggered by a large currency depreciation) of the type observed in past episodes of turmoil in emerging market economies. This outcome is even more noteworthy if one considers that banks' balance sheets were highly exposed to currency and credit risks arising from extensive euroization. These risks remained mostly contained as the fixed or quasi-fixed exchange rate regimes held up, while the depreciation of the Albanian and Serbian exchange rate did not trigger disruptive balance sheet effects.

The resiliency shown by the banking systems owes to a significant extent to the overall sound financial conditions prevailing in these systems in the run-up to the crisis as well as to progress in strengthening the regulatory and supervisory frameworks. High capital and liquidity buffers, which acted as the first line of defense against financial instability, were the outcome of a proactive approach to regulation and supervision on the part of the SEE-6 countries' central banks[84].

The banking systems that suffered the least (Albania and FYR Macedonia) were those where the funding model relied more heavily on domestic deposits rather than on external financing (usually from foreign parent banks).

A crucial role that is worth emphasizing is that played by macroprudential measures. In spite of their limited ability to effectively contain credit growth or external borrowing (their intended goals), these measures provided an important contribution to preserving financial stability by allowing the buildup of higher liquidity and capital buffers[85]. The latter proved to be decisive in strengthening the ability of these banking systems to weather the crisis.

In the case of Croatia, there is supporting evidence on the contribution from specific instruments used by the CNB prior to the crisis to stimulate (to some extent, unintentionally) the buildup of banks' liquidity and capital buffers (Galac, 2010). The marginal reserve requirement (MRR) is the most prominent example, despite the fact that it was little successful in achieving its stated goal of reducing the growth rate of banks' foreign (wholesale) liabilities in the period of abundant international liquidity. Interestingly, the MRR may have contributed to building capital buffers by raising the cost of external borrowing, which in turn made capital raising a relatively less expensive form of funding (Jankov, 2009, p. 128)[86].

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[84] For example in the case of Croatia, Galac (2010) provides evidence that the ability of the central bank to avert a currency and/or banking crisis and stabilize the financial system in 2008-09, through a loosening of its foreign exchange policy, owes significantly to the policy of "leaning against the wind" adopted from 2003 to early 2008, which was characterized by an aggressive build-up of central bank and commercial bank foreign currency liquidity buffers and capital reserves.

[85] "*The registered increase in the capital adequacy ratio.... was in part the result of monetary policy measures aimed at slowing down the growth of bank placements, prompting banks to increasingly use their capital as a source of growth*" (CNB, 2007b, p. 90). "*Resilience of the* ...[banking]...*sector was to a large extent due to high liquidity and strong capital base built by the counter-cyclical monetary and supervisory measures implemented prior to the crisis*"(NBS, 2008, p. 84).

[86] "*Banks' primary funding sources steadily trended upward due to continued injections of new capital into banks, which were used to cut regulatory costs arising from foreign borrowing*" (CNB, 2009, p. 36).

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It is also important to underscore that some of the macroprudential measures adopted to contain external borrowing *de facto* helped buildup a sort of contingent reserve of foreign exchange. In fact, the release of reserve requirements on foreign borrowing was a key measure, most notably in Croatia and Serbia, which helped sustain financial stability, as it allowed banks to meet the withdrawals of FX deposits and provide credit to the economy.

Given that their banking systems were largely foreign-owned, the global crisis faced the SEE-6 countries with the risk of a sudden stop or reversal of external financing from Western European banks to their local subsidiaries, a development that could aggravate the impact of the crisis. An even worse scenario was one where local subsidiaries could cut down on their exposure to accommodate recapitalization needs of their parent banks.

However, contrary to these early concerns, all foreign banks remained in the region and proved to be able to continue supporting their subsidiaries. Outflows were more limited in countries with higher penetration of foreign banks, and some countries even experienced inflows (Berglöf *et al*, 2009, p. 13; IMF, 2010k, p. 61). According to some empirical evidence, emerging Europe suffered more contained outflows of bank lending than other emerging regions (Berglöf *et al*, 2009).

Ultimately, the resiliency of foreign banks' exposures to the SEE-6 countries helped contain the impact of the crisis and exerted a stabilizing effect[87]. This was particularly relevant in Bosnia-Herzegovina and Serbia, because the private sector was involved in the macroeconomic adjustment effort. A key role in this regard was played by the European Bank Coordination Initiative (EBCI), also known as the "Vienna Initiative" (IMF, 2010k): a formal bail-in agreement that involved specific voluntary commitments on the part of foreign banks to maintain their exposures to five emerging European countries with an IMF program at the same level as (or higher than) that prevailing at end-2008 as well as to recapitalize their domestic subsidiaries[88]. The ensuing broadly successful rollover of these exposures was helped by the presence of some favorable conditions, such as the limited number of foreign banks to coordinate[89] or the absence of rollovers involving sovereign debt (Berglöf *et al*, 2009)[90]. Even in the absence of formal coordination mechanisms such as the Vienna Initiative, foreign banks supported their local subsidiaries, for example in Croatia and Montenegro.

[87] However, since credit booms and high external indebtedness *before* the crisis are associated with large output declines *during* the crisis, a question arises of whether, in so far as foreign banks facilitated rapid credit growth and external borrowing, "*they may be mitigating a problem of their own making*" (EBRD 2009, p. 68).

[88] As a positive externality of these recapitalization commitments, national supervisors were forced to strengthen their stress testing capabilities.

[89] In Serbia, rollover rates remained at a relatively higher level than the other participants in the EBCI chiefly because of the authorities' ability to closely monitor the agreed bank-by-bank exposure floors based on monthly reporting requirement (IMF, 2011g).

[90] According to the authors, the role of international banking groups in the financial sectors of emerging European counties, together with political and economic proximity to (and, in some cases, membership in) the European Union, are two unique structural characteristics that help account for the financial resilience displayed by emerging Europe.

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Despite the overall resilience shown by the banking systems of the SEE-6 countries, the crisis nonetheless had a significant impact. All banking systems suffered from deterioration in financial soundness indicators, most notably lower profitability and rapidly rising NPLs, while capital adequacy ratios remained broadly adequate (Table 12). The (already large) degree of euroization usually intensified on both the asset and the liability side.

Table 12

	2005	2006	2007	2008	2009	2010
Bank Nonperforming Loans to Total Loans (in percent)						
Albania	2.3	3.1	3.4	6.6	10.5	13.9
Bosnia-Herzegovina	5.3	4.0	3.0	3.1	5.9	11.4
Croatia	6.2	5.2	4.8	4.9	7.8	11.2
FYR Macedonia	15.0	11.2	7.5	6.7	8.9	9.0
Montenegro	5.3	2.9	3.2	7.2	13.5	21.0
Serbia	n.a.	n.a.	n.a.	11.3	15.5	16.9
Return on Equity (in percent)						
Albania	22.2	20.2	20.7	11.4	4.6	7.6
Bosnia-Herzegovina	6.2	8.5	9.0	4.3	0.8	-5.5
Croatia	15.1	12.7	10.9	9.9	6.4	7.0
FYR Macedonia	7.5	12.3	15.0	12.5	5.6	7.3
Montenegro	6.1	11.6	10.6	-6.6	-6.9	-27.0
Serbia	6.5	9.7	8.5	9.3	4.6	5.4
Bank Regulatory Capital to Risk-Weighted Assets (in percent)						
Albania	18.6	18.1	17.1	17.2	16.2	15.4
Bosnia-Herzegovina	17.8	17.7	17.1	16.3	16.1	16.2
Croatia	15.2	14.4	16.9	15.4	16.6	18.8
FYR Macedonia	21.3	18.3	17.0	16.2	16.4	16.1
Montenegro	27.9	21.3	17.1	15.0	15.8	15.9
Serbia	26.0	24.7	27.9	21.9	21.3	19.9

Source: IMF, *Global Financial Stability Report* (April 2011; September 2011)

These developments led to a large deceleration (or a stop) of credit growth, compounded by such factors as higher risk aversion, tightened credit standards, and uncertainty over economic prospects[91]. Moreover, in the face of reduced external funding and under pressure to strengthen their domestic deposit base, banks increased interest rates on deposits, a move that somewhat reduced the room for lowering interest rates on loans (NBS, 2009, p 44; IMF, 2009f, p.14).

[91] In Croatia and Serbia, the governments established programs to counter the decline in private credit growth, although interest subsidies and loan guarantees could bear some fiscal risks.

In the very short-term, the main threat to financial stability was posed by panic-driven deposit withdrawals that, to different degrees, followed the failure of Lehman Brothers in September 2008, and were at times exacerbated by concerns on the stability of Western European parent banks.

For example, in the fourth quarter of 2008, deposits declined by around 18 percent in Serbia (IMF, 2010e, p. 9) and 8 percent in Albania, and started to recover gradually from the second quarter of 2009[92]. In Bosnia-Herzegovina, a spate of negative news about foreign parent banks of local subsidiaries prompted households to withdraw, over a single month, around 13 percent of their sight deposits and almost 11 percent of their savings and time deposits (European Commission, 2010). Overall, withdrawal of foreign currency deposits and conversion of cash and deposits in domestic currencies into cash in foreign currencies led to a decline in deposits by 3.4 percent of GDP between October 2008 and March 2009. This decline contributed to the loss of part of the central bank's gross international reserves (16 percent between September 2008 and May 2009).

The situation stabilized quickly, as the affected banks received emergency cash from their foreign parents, and drew down their excess reserves with the central bank. Private deposits flew back at the end of 2009, allowing foreign parent banks to scale down their support for local subsidiaries. However, faced with increased provisioning and lower profitability, banks reacted by raising interest rates on loans, further tightening credit conditions (IMF, 2009g). Since the effectiveness of supervision was affected by the fragmentation of the country's regulatory system, an important component of the policy response to the crisis involved the establishment of a Standing Committee on Financial Stability, which provided a cooperative arrangement for crisis management and crisis preparedness.

Montenegro stands out as the banking system suffered a deposit outflows that was more persistent than in neighboring countries (it went on until early 2011). This was partly due to the fact that foreign parent banks initially supported their local subsidiaries with additional funding. But after deposits started flowing back in April 2009, they clawed back their earlier support. Since financing from parent banks had been increasingly funding the credit boom, the reduced financing to local subsidiaries resulted in a credit crunch that overtook the fiscal tightening as a cause of the severe economic contraction (IMF, 2010f). However, facing pressure from the central bank, foreign parents eventually stepped in with substantial liquidity infusions to their Montenegrin subsidiaries as well as with purchases of bad assets, subordinated debt, and capital injections (about 7 percent of GDP between 2008 and 2010). The central bank provided emergency support to the largest bank, and placed public sector deposits in it.

Contrary to previous cases, in FYR Macedonia deposit withdrawals were limited and the banking system suffered only modestly from the global crisis, mainly on the account of a conservative business model, the banks' highly liquid assets (for example, central bank bills),

[92] In Albania, this decline led to an increase in banks' foreign borrowing to fund domestic activities or meet liquidity needs (in fact, part of this borrowing reflected financial support from parent banks to their local subsidiaries). As a consequence, in the first half of 2009 the Albanian banking system became for the first time a net debtor to non-resident for few months (BoA, 2008, p. 68; BoA, 2009, p. 79; BoA, 2010, p.74).

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and their primary reliance on domestic deposits as a funding source. Moreover, due to their relative insulation from the global financial system, FYR Macedonia's banks were affected by the crisis mainly through its impact on the real economy (and rising NPLs), rather than directly from external funding pressures. This notwithstanding, between September 2008 and September 2009 annual deposit growth fell from 25 percent to zero percent, lending growth fell from 29 percent to 6 percent.

The financial systems of Albania and Serbia faced somewhat different challenges than their peers as a result of their flexible exchange rate regimes. In Albania, the direct risks posed by a depreciation of the currency were mitigated by the fact that the banking system as a whole benefited from a small positive foreign position. In Serbia, unhedged private FX exposures suffered as a consequence of the dinar depreciation (20 percent between September 2008 and March 2009), and contributed to the decline in households' FX deposits.

The authorities in the SEE-6 countries acted promptly to fend off the immediate fallout of the crisis and to preserve financial stability through a number of measures. To begin with (and crucially), the coverage of deposit insurance was substantially raised in all SEE-6 countries. Banks were generally able to accommodate deposit withdrawals and liquidity shortages by drawing down their large capital and liquidity buffers.

Bank liquidity was also critically boosted by central banks, including through the active use of regulatory tools, most notably a relaxation of key reserve requirements. In Bosnia-Herzegovina, reserve requirements were lowered from 18 to 14 percent in October 2008, and a further reduction of these requirements on long-term liabilities was adopted in 2009. In Serbia the reserve requirement base was lowered and reserve requirements on new foreign borrowing were abolished. In Croatia, the relaxation of regulatory requirements[93] allowed the release of foreign currency liquidity buffers that had been built-up during the pre-crisis period, which provided the funds needed to counter the deposit withdrawals from the banking sector (Bokan et al, 2009, p. 7). It has also been estimated that 50 percent of the bank liquidity freed up by the central banks through lower reserve requirements was used up to finance the significant increase in government borrowing undertaken to cover the budget deficit (Jankov, 2009). In turn, this may account for the absence of a major slowdown in foreign borrowing by banks (Bokan et al, 2009, p. 37).

V. Concluding Remarks

The global crisis hit the SEE-6 countries at a time when they were experiencing rising external vulnerabilities, while policy space for a discretionary countercyclical response was generally very limited or nonexistent. As a consequence, the crisis exerted a significant and, in some key respects, lasting impact on these countries.

[93] The marginal reserve requirement on banks' foreign borrowing was eliminated in October 2008, in order to help attract new funds from parent banks abroad; the general reserve requirement was lowered from 17 percent to 14 percent in December 2008; and the foreign currency liquidity ratio was lowered in three steps from 32 percent in May 2008 to 20 percent in May 2009.

The reduction in the availability of foreign capital imposed rapid adjustments in domestic demand that, together with a collapse in exports, resulted in substantial output declines. Resolute domestic policy responses to the crisis, at times supported by official financing packages from multilateral institutions and by the involvement of foreign parent banks, helped avoid full-fledged currency-cum-banking crises of the type observed in the past.

While the global turmoil hit the SEE-6 countries in fairly similar modalities, some differences in the impacts of the external shocks can be accounted for by the fact that procyclical expansionary fiscal policies adopted by four countries in the years immediately prior to the global crisis (against the advice of the Fund) worsened external imbalances and the dependence on (seemingly lasting) foreign financing. As a result, when external financial conditions deteriorated, the SEE-6 countries with high external financing requirements found themselves in a very vulnerable position. In Serbia and Bosnia-Herzegovina, external financing gaps opened up, and the Fund's financial support was needed to cover them. It is worth noting that, in both cases, actual external financing requirements turned out to be lower than initially projected, chiefly a consequence of faster-than-envisaged adjustments in the current account deficits. In the case of Serbia, only half of the resources available under the augmented SBA were drawn, and the country was able to access private capital markets (through T-bill auctions) in the second half of 2009, earlier than expected[94]. Fund resources were eventually used to strengthen foreign exchange reserves and to reinforce these countries' abilities to withstand external and financial vulnerabilities.

Equally importantly, expansionary fiscal policies virtually dissipated the policy space for a discretionary countercyclical response to contain the deep downturn triggered by the external shock. On the contrary, more cautious fiscal policies in Albania and Croatia contributed to supporting these countries' abilities to retain market confidence and to continue covering their external and fiscal financing requirements without official assistance. Notwithstanding this similarity, it is striking that the growth performances of these two countries during the crisis were at the extremes of the spectrum, as Albania continued growing at a still satisfactory pace, while Croatia suffered the deepest and longest recession within the group.

The impact of the global crisis has left important legacies for the SEE-6 countries, most notably in terms of deteriorated fiscal positions, higher nonperforming loans, and tighter credit conditions, which will all have to be decisively dealt with in order to lastingly improve the growth prospects.

As the recovery takes hold, addressing the deterioration in public finances, with both increased budget deficit- and debt-to-GDP ratios, is a key priority in ensuring debt sustainability and in improving the scope for appropriate market financing of the government budget. The SEE-6 countries have generally embarked on programs of fiscal consolidation that aim to reduce the government budget deficit to sustainable levels (and in some cases, to balance) in the medium-term. The largest fiscal consolidations so far have taken place in Bosnia-Herzegovina and Serbia, in the context of a Fund-supported adjustment program. The credibility of these programs, which usually involve the reduction of large public wage bills,

[94] See IMF (2011g) for an ex post assessment of the IMF-supported program for Serbia.